REPORT #672

TAX SECTION

New York State Bar Association

REPORT ON SECTION 1031 PROPOSED TREASURY REGULATIONS
PROVIDING ADDITIONAL RULES FOR EXCHANGES OF
PERSONAL AND MULTIPLE PROPERTIES

October 31, 1990

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Tax Report #672

TAX SECTION
New York State Bar Association

November 1, 1990

The Honorable Fred T. Goldberg, Jr.
Commissioner of Internal Revenue
1111 Constitution Avenue
Washington, D.C. 20224

Dear Commissioner Goldberg:

I enclose a report on the Proposed Regulations issued under Section 1031 of the Internal Revenue Code concerning exchanges of personal and multiple properties. The report was prepared by a Committee chaired by Henry M. Conn, Michael Hirschfield and Victor F. Keen. The principal authors were Henry M. Cohn, Victor F. Keen, Ann-Elizabeth Purintun, Michael Hirschfeld, Martin Edelstein and Tiberio Schwartz.

While we generally commend the Regulations as setting forth useful guidance in an area which has had The benefit of little precedent, we take exception to Certain aspects of the Regulations. The most significant of our objections are to the position taken in the Regulations that goodwill can qualify as like kind only under "rare and unusual circumstances" and to the use of extremely narrow five-digit product codes in the implementation of one of the safe harbors. In addition, the report (a) suggests the adoption of rules that would facilitate the exchange of similar businesses, (b) suggests that excess liabilities assumed should be treated in the same fashion as cash transferred in the exchange (and that Treasury Regulation section 1.1031(d)-2 should be modified to permit cash received to be offset by liabilities assumed) or, alternatively, that taxpayers should be Permitted to elect to net nonrecourse liabilities within Exchange groups and to allocate excess nonrecourse Liabilities assumed to the exchange groups containing The property by which the liabilities are secured and (c) Suggests elimination or modification of the proposed Rule regarding liabilities incurred "in anticipation of" an exchange.

We would be happy to discuss any of our Recommendations with your staff at their convenience.

Very truly yours,

Arthur A. Feder
Chair

Enclosure

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Tax Report #672

NEW YORK STATE BAR ASSOCIATION TAX SECTION

COMMITTEE ON INCOME FROM REAL PROPERTY AND
COMMITTEE ON PERSONAL INCOME

REPORT ON SECTION 1031 PROPOSED TREASURY REGULATIONS PROVIDING ADDITIONAL RULES FOR EXCHANGES OF PERSONAL AND MULTIPLE PROPERTIES

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PERSONAL AND MULTIPLE PROPERTIES*

I. INTRODUCTION

On April 26, 1990, the Internal Revenue Service (the "Service") promulgated proposed regulations under section 1031 of the Internal Revenue Code that provide rules governing exchanges of personal property and of multiple properties. Regulation section 1.1031(a)-2 provides certain safe harbors and other rules Used in determining whether various types of personal property are of "like kind" for purposes of section 1031. Regulation section 1.1031(f)-l provides rules governing the computation of gain recognized and adjusted basis in connection with multiple Property exchanges. The proposed regulations also contain a "Clarifying" amendment to section 1.1031(b)-l(c) that relates to Liabilities incurred in anticipation of a section 1031 exchange.

II. SUMMARY OF PROPOSED REGULATIONS

The proposed regulations set forth rules for Determining whether personal property has been exchanged for Property of a "like kind." Depreciable tangible personal Property held for productive use in a business is exchanged For property of a like kind if the property is exchanged For property that is either of a like kind or of a like class. The exchanged properties are of a like class if they are within either of two

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* This report was prepared by a subcommittee of the Committee on Income from Real Property and the Committee on Personal Income, chaired by Henry M. Cohn, Michael Hirschfeld and Victor F. Keen. The principal authors of the report were Henry M. Cohn, Victor F. Keen, Ann-Elizabeth Purintun, Michael Hirschfeld, Martin Edelstein and Tiberio Schwartz. Helpful comments were received from Arthur A. Feder.

safe harbors based on generally available classification systems — if they are classified in the same "General Business Asset Class" (based on asset classes set forth in Rev. Proc. 87-*56,* 1987-2 C.B. 674, which provides a classification system for the purpose of determining depreciation deductions under section 168 of the Code) or in the same "Product Class" (based on the 5-Digit product classes under the product coding system of the U.S.Department of Commerce's Numerical List of Manufactured and Mineral Products).

No like classes are provided for intangible personal property, nondepreciable personal property, or personal property Held for investment. Exchanges of such properties can qualify for nonrecognition under section 1031 only if the exchanged properties are of a like kind. Whether intangible personal property is of a like kind to other intangible personal property depends not only on the type of right involved but also on the type of underlying property to which the intangible personal property relates. The proposed regulations adopt a very stringent approach to exchanges of goodwill or going concern value. Only in "rare and unusual circumstances" is the goodwill
Or going concern value of one business of a like kind to the goodwill or going concern value of a similar business.

As a general rule, the proposed regulations apply Section 1031 on a property-by-property basis. Thus, the proposed regulations do not permit an entire business to be treated as a single property for purposes of section 1031. However, the proposed regulations do permit the computation of gain realized and gain recognized to be made on an aggregate basis to a certain extent in an exchange of multiple properties.

The amount of gain recognized in an exchange of

Multiple properties is computed by first separating the Properties transferred and the properties received by the Taxpayer in the exchange into "exchange groups." Each exchange group consists of properties transferred and received in the Exchange, all of which are of a like kind or like class.

Next, all liabilities assumed by the taxpayer as part Of the exchange are offset by all liabilities of which the Taxpayer is relieved as part of the exchange. (In the proposed regulations and in this report, liabilities assumed by the taxpayer include liabilities to which property received by the Taxpayer is subject, and liabilities of which the taxpayer is relieved include liabilities to which property transferred by the Taxpayer is subject.) Excess liabilities assumed by the taxpayer are allocated among the exchange groups in proportion to the aggregate fair market value of the properties received by the taxpayer. Excess liabilities of which the taxpayer is relieved are, in effect, treated as ish received by the taxpayer in the exchange. If the section 1031 exchange is part of a larger transaction, the foregoing rules are applied to all the liabilities involved in the larger transaction.

If in an exchange group the aggregate fair market value of the properties transferred exceeds the aggregate fair market value of the properties received (i.e. if there is an "exchange group deficiency"), a portion of the other property or money received as part of the exchange is allocated to the exchange group in order to equalize the aggregate fair market value of the properties transferred and the properties received. If in an exchange group the aggregate fair market value of the property received exceeds the aggregate fair market value of the property transferred (i.e., If there is an "exchange group surplus"), the excess is allocated to other exchange groups, where it is treated as other property or money received in the exchange. Gain is recognized with; ###pect to each exchange group to the extent of the lesser of t### gain realized or the amount of the exchange group deficien### if any.

The aggregate basis of properties received in each of the exchange groups is the aggregate adjusted basis of the properties transferred by the taxpayer within that exchange group, increased by the amount of gain recognized by the taxpayer with respect to that exchange group, increased by the amount of the exchange group surplus or decreased by the amount of the exchange group deficiency with respect to that exchange group, and increased by the amount, if any, of excess liabilities assumed by the taxpayer that are allocated to that exchange group. The resulting aggregate basis of each exchange group is allocated proportionately to each property received in the exchange group in accordance with its fair market value.

Section 1.1031(b)-l(c) of the existing regulations provides that where each party to the exchange either assumes a liability of the other party or acquires property subject to a liability, then, in determining the amount of "other property or money" (i.e. "Boot") for purposes of section 1031, consideration given in the form of an assumption of liabilities (or a receipt of property subject to a liability) is offset against consideration received in the form of an assumption of liabilities (or a transfer of property subject to a liability). The proposed regulations amend existing section 1.1031(b)-l(c) to provide that consideration received by the taxpayer in the form of an assumption of liabilities may not be offset by consideration given by the taxpayer in the form of an assumption of liabilities to the extent of any liabilities incurred by the taxpayer "in anticipation of" an exchange under section 1031. This amendment is described as a "clarification" of current law.

III. SUMMARY OF COMMENTS

Although we generally commend the proposed regulations for providing clear guidance in an area which has previously had the benefit of very little useful precedent, we strongly object to the position taken by the regulations that exchanges of goodwill qualify as like kind only under "rare and unusual circumstances." The more significant and less technical of our comments are:

1. While we favorite presence of both the safe Harbors provided by the Product Classes and General Business Asset Classes and a facts and circumstances test for determining like kind status, we suggest an expansion of the safe harbors and an explanation of which facts and circumstances might be relevant.

In particular, since we believe that the five-digit Product Codes utilized in one of the safe harbors involve such narrow categories as to be of virtually no value, we strongly suggest the adoption of broader categories for that safe harbor.

2. We favor the creation of rules that would facilitate the exchange of similar businesses, by providing either an exception to the exchange group approach for exchanges of similar businesses or a narrower safe harbor, such as an exception for property that is incidental to a larger item of property. Furthermore, we believe the position taken by the regulations that the goodwill of similar businesses is treated as like kind only in rare and unusual circumstances is unjustified.

3. We believe that excess liabilities assumed should be treated the same as cash transferred in the exchange, and we suggest that Treasury Regulation section 1.1031(d)-2 be modified to permit cash received to be offset by liabilities assumed.

4. Alternatively, we suggest that taxpayers should be permitted to elect to net nonrecourse liabilities within exchange groups and to allocate excess nonrecourse liabilities assumed to the exchange groups containing the property by which the liabilities are secured.

5. We question the justification for the rule in Proposed regulation section 1.1031(b)-l(c) (regarding liabilities incurred by the taxpayer "in anticipation of an exchange) and suggest that, at a minimum, some safe harbors or presumptions be provided.

IV. DETAILED ANALYSIS

§ 1.1031(a)-2. Additional Rules for Exchanges of Personal Property

This section of the proposed regulations provides detailed rules for determining whether depreciable tangible personal property held for productive use in a business is exchanged for property of a like kind for purposes of section 1031. More general rules are provided for other types of personal property.

§ 1.1031fal-2(b). Depreciable tangible personal property held for productive use in a business is exchanged for property of a like kind if it is exchanged for property of a like kind or a like class. In general, properties are of a like class if they are either within the same General Business Asset Class (one of asset classes 00.11 through 00.28 and 00.4 set forth in

Rev. Proc. 87-56, 1997-2 C.B. 674, as modified) or within the same Product Class he ’ e-digit Product Code in the Commerce Department's Numerical LJ - of Manufactured and Mineral Products (Issued February 1989)).

Comment: We believe the adoption by the proposed regulations of objective guidelines based on generally available classification systems is a sound approach to the problem of determining whether properties are of like ### for purposes of section 1031. In our view, such an approach is preferable to relying entirely on general standards that would have to be applied to the particular facts and circumstances of each case. We believe the use of the General Business Asset Class guidelines will give a clear answer to many questions regarding section 1031 qualification of exchanges of depreciable tangible personal property. However, the Product Codes involve such narrow categories that they will be of very limited use to taxpayers. For example, woven carpets and tufted carpets are listed in different Product Codes, as are metal caskets and wood caskets. For this reason, we strongly suggest the use of broader categories (e.g. three-digit or four-digit, rather than five-digit, product codes).

For the sake of clarity, we suggest that the second sentence of section 1.1031(a)-2 be amended to provide that, except as provided in paragraph (b) (4), exchanged properties are of a like class if and only if they are either within the same General Business Asset Class or within the same Product Class.

§ 1.1031(a)-2(b) (l). Under an ordering rule, property within any General Business Asset Class may not be classified within a Product Class.

Comment: Under this rule, if two properties would be classified within the same Product Class but belong to different General Business Asset Classes (or if one of the properties is within a General Business Asset Class and the other is not), the properties are not treated as of a like class. We question the necessity for this rule. We believe it would be more reasonable for the regulations to treat properties as of like class if they have the same Product Code. We do not believe it is appropriate to disqualify from the safe harbor two properties with the same Product Code merely because they belong to different General Business Asset Classes, or because one of them is classified within a General Business Asset Class and the other is not. (Neither situation seems very likely to occur, given that the General Business Asset Classes are relatively broad and the Product Codes generally involve very narrow categories of property.)

§ 1.1031(a)-2(bl (4). If depreciable tangible personal property is not listed in a Product Code, or if the Product Code of such property is a miscellaneous category, the determination of whether the exchanged properties are of a like class is made based on all the facts and circumstances. In addition, section 1.1031 (a) -2 (a) states that "an exchange of properties of a like Kind may qualify under 1031 regardless of whether the properties are also of a like class."

Comment: Taken literally, this provision seems to apply to any property that is not listed in a Product Code (or is listed in a miscellaneous category), even if the property is listed in a General Business Asset Class. Moreover, the provision might be read to apply in a case where property with no (or a miscellaneous) Product Code is exchanged for property that is within a General Business Asset Class or a Product Class. We believe the drafters probably intended the provision to apply only to properties neither of which is classified in a General Business Asset Class or a Product Code (other than a miscellaneous category). We believe this is the appropriate rule and that the provision should be clarified accordingly.

Since the like class determination is generally based solely on fitting into existing classification systems, there is no indication as to the basis on which the determination might be made under a facts and circumstances test. We believe that guidance should be given (in the form of a list of relevant factors or examples) if the concept of like class has independent Significance other than as a safe harbor (i.e., if it is possible for two properties to be of a like class though not otherwise of a like kind). On the other hand, if like class is merely a subcategory of like kind, we question the need for a special facts and circumstances like class test.

Properties not fitting into the like class safe harbors (and which are not otherwise of like class) may nevertheless, according to the proposed regulations, be of like kind. In general, we endorse an approach that provides both clear and objective safe harbors and an opportunity for taxpayers to qualify based on their particular facts and circumstances. However, as in the case of the like class determination, it would be desirable for the proposed regulations to give some additional guidance as to cases in which properties are of like kind though not of like class, rather than leaving taxpayers to rely on the minimal guidance provided by existing case law and rulings. The only regulatory guidance provided is the statement that whether two properties are of like kind depends on the nature or character of the properties rather than their grade or quality.

Presumably, the drafters had in mind some general concepts of both like kind and like class. It would be helpful if some guidance were provided, perhaps by way of examples. The regulations should indicate, for example, that the fact that property received is to be used for a different purpose than property transferred does not bear on like class or like kind status. Prior to 1924, the predecessor of section 1031 provided for nonrecognition upon an exchange of investment or business property for property of "like kind <u>or use</u>." (Emphasis added.) The legislative history of the 1924 provision states that "if the property received is of a like kind, it is immaterial whether it is to be held for investment or for productive use."[1] Furthermore, the proposal by the House of Representatives in the Omnibus Budget Reconciliation Act of 1989 to conform section 1031 to the requirement of section 1033 that the properties involved be "similar or related in service or use" was rejected. In light of this authority, we believe that the intended use of the property involved is generally not relevant.

The regulations should also clearly indicate whether properties can be of like class though not otherwise of like kind. Finally, we suggest the regulations should explicitly state that, in determining whether two properties are of like kind, no negative inference should be drawn from the fact that the properties are not of like class — i.e., Where the properties are in different General Business Asset Classes or Product Classes, or where one property is in a Product Class or General Business Asset Class while the other property is not in any Product Class or General Business Asset Class.

S 1.1031(a)-2(c). The proposed regulations take the position that intangible personal property, nondepreciable personal property, and personal property held for investment qualify for nonrecognition under section 1031 only if the exchanged properties are of a like kind. Whether intangible property is of a like kind generally depends not only on the type of right involved but also on the type of underlying property to which the right relates. The goodwill or going concern value of dissimilar businesses is not of like kind, and the goodwill or going concern value of similar businesses is of like kind only in "rare and unusual circumstances."

[1] S. Rep. No. 398, 68th Cong., 1st Sess. 276 (1924).

Comment: No like class safe harbors are provided for these types of property (nor can such properties be of a like class under a facts and circumstances test). . In view of the legislative history of the predecessor of section 1031, and the rejection of the proposal by the House of Representatives in the Omnibus Budget Reconciliation Act of 1989 to conform section 1031 to the requirement of section 1033, noted above, we suggest that the status of property as business or investment property should not be relevant, and consequently, the General Business Asset Class and Product Class safe harbors should be extended to depreciable tangible personal property held for investment or used by the taxpayer in its investment activities.

Moreover, apart from the availability of standard Classification systems for tangible personal property (i.e., safe harbors), we question why the concept of like class should apply only to tangible depreciable personal property. Here again, if we had a general sense of what the drafters mean by "like class" and "like kind," we might have a clearer notion whether this is the appropriate rule. If, on the other hand, the drafters intend the "like class" concept to be only a safe harbor for certain enumerated types of property, the regulations should clearly

Indicate this and should not imply that there -a is some deeper meaning to the concept.

We suggest the regulations indie that intangible rights of the same type with respect to tangible property that is of like kind or like class are of a like kind. For example, a patent on a computer and a patent on a printer should be treated As like kind, since the patents are the same type of intangible right and the underlying property is of like class. Furthermore, the regulations should indicate that similar intangible rights, such as patents, secret processes and possibly trademarks, are of the "same type" for this purpose.

We strongly object to the position taken by the regulations that exchanges of goodwill qualify as like kind only under "rare and unusual circumstances," particularly when it is apparent from example (3) of section 1.1031(a)-2(c)(3) that the rule would, as a practical matter, foreclose nontaxable exchanges of goodwill. Given (i) the historically liberal treatment of exchanges of real property, (ii) the recent rejection of the attempt to narrow the application of section 1031 by requiring that properties exchanged be "similar or related in service or use," and (iii) the legislative history of section 1031 (which, from time to time, has been amended, by adding specific, enumerated exceptions to the general rule), we see no justification for singling out goodwill for an especially restrictive rule, and we believe there might well be a question as to the proposed regulations validity this point.

Although there is some tension between the existence of Goodwill (i.e.. the tendency of customers to patronize a business) and the position taken in the regulations that a "business" must be analyzed as a collection of separate assets, we believe the regulations should treat a business as a single property for purposes of analyzing an exchange of goodwill (even if that position is not adopted in the regulations generally) and should treat goodwill with respect to similar businesses as of a like kind.

If the proposed treatment of goodwill is retained, it is important to provide rules, by example or otherwise, for exchanges of property related to goodwill or of which goodwill is inherently an element, such as customer lists, trademarks and trade names. These are similar to goodwill in that their value derives in part from the tendency of customers to purchase a particular product or name. (It is the general practice in the case of trademark assignments that the assignment includes the trademark and the goodwill of the business symbolized by the mark.) Similar concerns can arise in the case of exchanges of franchises.

The proposed treatment of goodwill is especially likely to result in the types of valuation disputes that the Service has recently had little success in winning. Indeed, although the stakes (amortizability v. non-amortizability) in the typical asset acquisition involving an allocation between goodwill and other assets are high, the stakes in a section 1031 exchange will be even higher, since the issue will be immediate gain recognition v. nonrecognition.

S 1.103(-1. Exchanges of Multiple Properties

s i.l03l(f)-l(a)(l). This section states a general rule that section 1031 is applied on a property-by-property basis to determine the amount of gain recognized and the basis of property received in a like kind exchange, and creates an exception in the case of an exchange of multiple properties. The exception applies only if there is more than one "exchange group."

Comment: The proposed regulations reject the treatment of a business as a single property, instead requiring that each asset transferred and received be treated separately. This rule, which the Service first explicitly enunciated in Rev. Rul. 89-121, 1989-2 C.B. 203, especially when combined with the regulations' exceedingly narrow treatment of goodwill, makes it difficult or impossible to exchange similar operating businesses without recognition of gain. Although Rev. Rul. 89-121 characterizes the "separate asset" rule as a "clarification" of Rev. Rul. 57-365, 1957-2 C.B. 521, and Rev. Rul. 85-135, 1985-2 C.B. 181, those rulings, which permitted exchanges of television stations and operating telephone companies, have effectively been revoked. Rev. Rul. 72-151, 1972-1 C.B. 225, involving the exchange of rental real property for farm land and farm equipment, rejects treatment of the farm as a single property, but this result is not inconsistent with a rule permitting like kind exchanges of similar businesses, since a rental real property business and a farm are not similar businesses.

We believe exchanges of similar businesses should qualify as like kind exchanges in certain circumstances. Although the separate property approach has long been used in taxable transactions, Williams v. McGowan, 152 F.2d 570 (2d Cir.1945), different considerations apply under section 1031. In a taxable transaction, gain, loss, character (capital v. ordinary), holding period, and basis must all be determined. In deciding whether it is appropriate to tax an exchange of one business for another business, or whether section 1031 should apply, the question should be whether the taxpayer has merely continued his investment, or whether he has changed the form of his investment sufficiently to justify recognition of gain or loss.

Although the legislative history of the predecessor of section 1031 is rather sparse and unilluminating, the section was originally enacted as part of an amendment that provided, first, that gain or loss realized upon an exchange of property for property was to be recognized only if the property received had a "readily realizable market value," and, second, that even if the property received had a readily realizable market value, gain or loss was not to be recognized if the property received was of like kind or use. Congress1 expressed intention was to remove the "grave uncertainties" involved in valuing property and thereby "permit business to go forward with the readjustments required by existing con##tions." S. Rep. No. 275, 67th Cong., 1st Sess. 189 (1921).

Since 1921, the Code has been amended to eliminate the requirement of a "readily realizable market value," but the concern over valuing property still remains and is reflected in other provisions, such as section 1274. We doubt that Congress could have intended that, for example, an exchange of laundry businesses should be subject to tax, either because the business transferred had more delivery trucks and fewer washing machines, while the business received ha fewer delivery trucks and more washing machines, or because each business included goodwill.

We strongly ### the adoption of rules that would permit an exchange of similar businesses (based on some business classification criteria, such as the Standard Industrial Classification Codes for lines of business used in the passive activity loss regulations to define "activity") to qualify as like kind under at least some circumstances. We would favor a rule that would treat the exchange of two businesses as like kind if both businesses were in the same line of business. If such a rule is not adopted, we would suggest, at a minimum, the creation of more limited rules that would still facilitate the exchange of similar businesses. For example, the regulations could provide that, in an exchange of similar businesses, minor variations (perhaps 15%) between the value of the property transferred and the property received in an exchange group would not be taken into account. The regulations could also provide that property which was "incidental to a larger item of property" within the meaning of proposed regulation section 1.1031(a)-3(c)(5) would be included in the same exchange group as the larger item of property.

Assuming that the regulations continue to require separate asset treatment in the case of the transfer of a business, it is unclear why the rule permitting aggregation of assets within an exchange group ("exchange group aggregation") should apply only when there is more than one exchange group. For example, if 500 computers are exchanged for 400 printers, exchange group aggregation does not apply; but if, in addition, the parties exchange two toasters used in their businesses, exchange group aggregation does apply. (Given the opportunity afforded by exchange group aggregation to net losses against gains, taxpayers would have an incentive to add the toasters to the exchange.) Since the policy reason for exchange group aggregation — simplicity — is equally applicable in both alternatives, it would seem preferable to extend the rule to cover cases where there is only one exchange group.

§ 1.1031(f)-l(a). The general approach of the multiple property exception is to first divide the exchanged assets into "exchange groups," with each exchange group consisting of transferred and received property that is of like kind or like class. Second, liabilities assumed and liabilities of which the taxpayer is relieved are netted (whether or not recourse and whether or not secured by specific property), and the net amount of the liabilities assumed or of which the taxpayer is relieved is allocated among the exchange groups or to the "residual group." Third, the amount of gain recognized with respect to each exchange group is computed, and the basis of each property received is determined. It is assumed that the aggregate amount realized with respect to properties transferred in an exchange group equals the aggregate fair market value of such properties.

Comment: The simplifying assumption is reasonable and is supported by case law such as Philadelphia Park Amusement Co. v. United States. 126 F. Supp. 184 (Ct. Cl. 1954), and United States v. Davis. 370 U.S. 65 (1962).

We suggest that the regulations should clarify whether or not an exchange group can consist of properties of a like class and a like kind. For example, if properties A and B are of a like class and properties B and C are of a like kind, do properties A, B and C belong in the same exchange group? If not, what ordering rule applies?

§ 1.1031(f)-1(b). Computation of gain recognized. To determine the gain recognized with respect to an exchange group, the aggregate fair market value of the property transferred within the exchange group is compared to the aggregate fair market value of the property received within the exchange group.

The excess, if any, of the value of the property transferred over the value of the property received is an "exchange group deficiency," while the excess, if any, of the value of the property received over the value of the property transferred is an "exchange group surplus."

Under section 1031(b), if a taxpayer receives both property that is like kind and property that is not ("boot"), the taxpayer recognizes gain to the extent of the lesser of the gain realized by the taxpayer or the value of the boot received. Under the simplifying assumption in section 1.1031(f)-l(a)(2),the amount realized with respect to property transferred in an exchange group equals the fair market value of such property. Therefore, the gain realized with respect to an exchange group equals the excess, if any, of the aggregate fair market value of the property transferred over the aggregate tax basis of such property. If the value of the property transferred exceeds the value of the property received in the exchange group, the taxpayer is presumed (because the entire transaction is presumed to be at arms' length) to have received in exchange for the transferred property other property with a value equal to the excess. Such other property would be either from other exchange groups or from the residual group. Section 1.1031(f)-l(b)(3) provides that the taxpayer must recognize gain in an amount equal to the lesser of the gain realized or the exchange group deficiency. Losses realized with respect to an exchange group may not be recognized.

Comment: The simplifying assumption in section 1.1031(f)-l(a)(2) makes the computation of the gain recognized relatively straightforward. While loss realized with respect to an exchange group nay not be recognized and nay not be used to offset gain realized with respect to another exchange group, loss realized within an exchange group nay be effectively recognized to the extent of gains within that group. This is illustrated by example (3) in section I.l03l(f)-l(d), in which the property transferred in the first exchange group consists of Computer A (value $5000, basis $1500), Computer B (value $3000, basis $500) and Printer C (value $1500, basis $2000), while the property received consists of Computer Z (value $4500) and Printer Y (value $2500). The gain realized is $5000 + $3000 + $1500 - $1500 - $500 - $2000 = $5500. In this computation, the $6000 gain in Computers A and B has been offset by the $500 loss in Printer C. In the example, since the exchange group deficiency is only $5000 + $3000 + $1500 - $4500 = $2500 - $2500, gain is recognized only to the extent of $2500, and the loss on Printer C has no effect. The use of the loss realized with respect to Printer C would be material if $4500 cash were received instead of Computer Z. In this alternative, the exchange group deficiency would be $7000, and the entire $5500 of gain would be recognized. Using a strict property-by-property approach (i.e., no exchange group aggregation and no netting of gains and losses), by contrast, the boot allocable to Computers A and B would be $7000 x 8000/9500 = $5895, and gain would be recognized o the extent of $5895 (the lesser of $5895 or the $6000 of gain realized with respect to Computers A and B).

We believe that the proposed regulations' method of computation is reasonable and is justified by simplicity. While a number of revenue rulings (such as Rev. Rul. 89-121, 1989-2 C.B. 203, and Rev. Rul. 72-151, 1972-1 C.B. 225) hold that in an exchange of multiple properties, separate analysis of each asset is required, the rulings do so in the context of deciding whether each asset qualifies for like kind treatment. We are not aware of any case or ruling addressing the method of computation of the gain recognized in a multiple property exchange governed by section 1031. Rev. Rul. 68-55, 1968-1 C.B. 140, requires gain recognized in a section 351 transfer to be determined on a property-by-property basis, and prohibits the use of losses realized on the transfer of some assets to offset gain realized on other assets. However, we believe that the opportunity for abuse present in a section 351 context is not generally present in the case of a section 1031 exchange. In a section 351 transaction, the transferor does not give up control of the transferred assets. If the transferor in a section 1031 exchange is willing to transfer an asset to a third party so as to recognize a loss, he could have sold the asset.

§ l.l03l(f)-(1) (b)(2)(iii) Treatment of liabilities This section provides that liabilities assumed by the taxpayer in an exchange are offset against all liabilities of which the taxpayer is relieved in the exchange, whether such liabilities are recourse or nonrecourse and whether or not such liabilities are secured by or otherwise relate to specific properties transferred or received as part of the exchange. Any excels of liabilities assumed over liabilities of which the taxpayer is relieved is allocated among the exchange groups in proportion to the aggregate fair market value of the properties received by the taxpayer in the exchange groups, but not in excess of the fair market value of the property received in each exchange group. Any excess of liabilities of which the taxpayer is relieved over liabilities assumed is allocated to the residual group, to the extent that cash would be so allocated. If the section 1031 exchange is part of a larger transaction, the foregoing rules are applied to all the liabilities involved in the larger transaction.

Comment: In general, the netting of liabilities seems reasonable. While it will often reduce the gain recognized by taxpayer , in many cases the benefit will be illusory. Compare the following two examples:

Example 1:

	Property Transferred	Property Received
Exchange Group A	Gross = 100 Debt = 20 Net = 80	Gross = 100 Debt = 0 Net = 100
Exchange Group B	Gross = 100 Debt = 0 Net = 100	Gross = 100 Debt = 20 Net = 80

In this example, the proposed regulations' approach results in no gain recognition, since there is no exchange group deficiency.

If the liabilities were not netted, there would be $20 of boot with respect to Exchange Group A, and gain realized with respect to Exchange Group A would be recognized to that extent.

Example 2:

	Property Transferred	Property Received
Exchange Group A	Gross = 120 Debt = 20 Net = 100	Gross = 100 Debt = 0 Net = 100
Exchange Group B	Gross = 100 Debt = 0 Net = 100	Gross = 120 Debt = 20 Net = 100

In this case, the netting rule does not change the amount of gain recognized. If the liabilities are netted, there is an exchange group deficiency of $20 with respect to Exchange Group A (and an exchange group surplus of $20 with respect to Exchange Group B). Consequently, gain realized with respect to Exchange Group A is recognized to the extent of $20. As in Example 1, if the liabilities were not netted, there would be $20 of boot with respect to Exchange Group A, and gain realized with respect to Exchange Group A would be recognized to that extent.

The regulations allocate "excess" (i.e.. net) liabilities assumed among the exchange groups in proportion to the fair market value of the property received in each exchange group. This can have the effect of creating an exchange group deficiency (and, therefore, potential gain recognition) where there would be none if the taxpayer transferred cash in lieu of assuming excess liabilities.

Example 3:

	Property Transferred	Property Received
Exchange Group A	80	100
Exchange Group B	100	100

In addition, the taxpayer assumes $60 and is relieved of $40 of liabilities.

Under the proposed regulations, the $20 of excess liabilities a- tied is allocated $10 to Exchange Group A and $10 to Exchange Group B. This results in a $10 exchange group surplus with respect to Exchange Group A and a $10 exchange group deficiency with respect to Exchange Group B.[2] If, instead of assuming $20 of excess liabilities, the taxpayer transferred $20 of cash, there would be a $20 exchange group surplus with respect to Exchange Group A and no exchange group deficiency with respect to Exchange Group B. The taxpayer would be treated as exchanging $80 of Exchange Group A property and $20 of cash for $100 of Exchange Group A property. Consequently, the taxpayer would not recognize any gain. (In either case, the other party would have an exchange group deficiency of $20 with respect to Exchange. Group A.)

[2] If the exchange groups in Example 3 were part of a larger transaction in which the taxpayer assumed a total of $600 of liabilities while being relieved of $40 of liabilities, the $560 of excess liabilities assumed would be allocated to Exchange Groups A and B to the full extent of the value of the property received, creating exchange group deficiencies of $80 with respect to Exchange Group A and $100 with respect to Exchange Group B.

We believe that excess liabilities assumed should be viewed as increasing what the taxpayer transfers, rather than reducing what he receives, in the exchange, just as excess liabilities of which the taxpayer is relieved are treated as increasing the boot the taxpayer receives, rather than reducing what he transfers. We therefore suggest that, instead of being allocated pro rata among the exchange groups, excess liabilities assumed should be allocated to the residual group to the extent such excess would be so allocated if it were treated as cash transferred in the exchange. This would parallel the treatment of excess liabilities of which the taxpayer is relieved.

Our suggested treatment of excess liabilities assumed, unlike the treatment adopted by the proposed regulations, would not always be consistent with section 1.1031(d)-2 of the existing regulations, under which excess liabilities assumed cannot offset cash received, while cash transferred can offset excess liabilities of which the taxpayer is relieved.

Example 4:

	Property Transferred	Property Received
Exchange Group A	80	100
Exchange Group B	100	100
Cash	-	10

In addition, the taxpayer assumes $70 and is relieved of $40 of liabilities.

Under the proposed regulations, the $30 of excess liabilities assumed is allocated $15 to Exchange Group A and $15 to Exchange Group B. This results in a $5 exchange group surplus with respect to Exchange Group A and a $15 exchange group deficiency with respect to Exchange Group B. Since up to $15 of realized gain is recognized with respect to Exchange Group B, the $10 cash received by the taxpayer has not been offset by the excess liabilities assumed. Under our suggested treatment, on the other hand, the $30 of excess liabilities assumed would be allocated to the residual group, where it would be netted against the $10 of cash received by the taxpayer. There would be a $20 exchange group surplus with respect to Exchange Group A and no exchange group deficiency with respect to Exchange Group B. Thus, the taxpayer would not recognize any gain on the exchange.

There appears to us to be no compelling reason for the rule prohibiting excess liabilities assumed from offsetting cash received, since the parties could restructure the transaction so that the other party would pay down the debt with the cash (business considerations such as nonprepayable debt aside). Also, a taxpayer who receives cash and assumes debt is economically in the same position that he would be in if he borrowed the cash directly. Such a borrowing would, of course, not be taxable. Therefore, we suggest that section 1.1031(d)-2 should be amended to permit cash received to be offset by debt assumed. There is cont###case law, however. See Coleman v. Commissioner. 180 F.2d 758 (8th Cir. 1950).

In the event our suggestion for allocating excess liabilities assumed is not adopted, we believe there should be a special rule for exchanges that involve nonrecourse debt secured only by property within a single exchange group. Under this rule, a taxpayer could elect, by forgoing the benefit of netting nonrecourse liabilities between exchange groups, to net nonrecourse liabilities only within exchange groups and allocate the excess nonrecourse liabilities assumed within any exchange group to that exchange group.

Example 5:

	Property Transferred	Property Received
Exchange Group A	Gross = 10 Debt = 0 Net = 10	Gross = 10 Debt = 0 Net = 10
Exchange Group B	Gross = 80 Debt = 20 Net = 60	Gross = 90 Debt = 30 Net = 60

Under the proposed regulations, the $10 of excess liabilities assumed is allocated $1 ($10 x 10/100) to Exchange Group A and $9 ($10 x 90/100) to Exchange Group B. Thus, there is an exchange group deficiency of $1 with respect to Exchange Group A and an exchange group surplus of $1 with respect to Exchange Group B. We believe this result is inappropriate, since each of the exchanges in this example could stand alone as an economic matter and would be nontaxable. The proposed regulations' treatment of excess liabilities assumed will therefore encourage taxpayers to artificially fragment transactions in order to avoid the application of the rule. Under our rule that would allocate excess liabilities assumed to the residual group, no exchange group deficiency would result. (There would be a $10 exchange group surplus with respect to Exchange Group B.) If our suggested rule for allocating excess liabilities assumed is not adopted, we believe that the taxpayer should be allowed to net within Exchange Group B the $20 of nonrecourse liabilities relieved and the $30 of nonrecourse liabilities assumed and allocate the $10 of excess nonrecourse liabilities assumed to Exchange Group B. There would then be no exchange group surplus or deficiency with respect to Exchange Group A or B.

A final example will further illustrate our suggested treatment of liabilities:

Example 6:

	Property Transferred	Property Received
Exchange Group A	Gross = 150 Debt = 100 Net = 50	Gross = 70 Debt = 0 Net = 70
Exchange Group B	Gross = 50 Debt = 0 Net = 50	Gross = 160 Debt = 110 Net = 50

In addition, the taxpayer assumes $60 and is relieved of $40 of recourse liabilities.

Under the proposed regulations, the $30 of excess liabilities assumed ($10 of excess nonrecourse and $20 of excess recourse liabilities) is allocated $9.13 ($30 x 70/230) to

Exchange Group A and $20.87 ($30 x 160/230) to Exchange Group B. Thus, the taxpayer is treated as receiving $60.87 ($70 - $9.13) of Exchange Group A property and $139.13 ($160 - $20.87) of Exchange Group B property. Accordingly, there is an exchange group deficiency of $89.13 with respect to Exchange Group A and an exchange group surplus of $89.13 with respect to Exchange Group B.

Under our suggested rule for allocating excess liabilities, the $30 of excess liabilities assumed would be allocated to the residual group. There would be an exchange group deficiency of $80 with respect to Exchange Group A and an exchange group surplus of $110 with respect to Exchange Group B. Under our alternative rule for nonrecourse indebtedness, the taxpayer could elect not to net the $100 nonrecourse debt in Exchange Group A and the $110 nonrecourse debt in Exchange Group B. The $20 of excess recourse liabilities assumed would be allocated $11.67 ($20 x 70/120) to Exchange Group A and $8.33 ($20 x 50/120) to Exchange Group B. (Note that the excess recourse liabilities assumed are allocated according to the net value of the property received.) With respect to Exchange Group A, the $11.67 of allocable excess recourse liabilities assumed and the $100 of nonrecourse liabilities relieved would be netted, the $88.33 of excess liabilities relieved would be allocated to the residual group, and there would be an exchange group deficiency of $80. With respect to Exchange Group B, the $8.33 of allocable excess recourse liabilities assumed would be added to the $110 of nonrecourse liabilities assumed, the taxpayer would be treated as receiving $41.67 ($160 - $118.33) of Exchange Group B property, and there would be an exchange group deficiency of $8.33 ($50 - $41.67).

S 1.1031(f)-1(b)(2)(iii). Residual group. If the aggregate net value of the property transferred in all of the exchange groups exceeds the aggregate net value of the property received in the exchange group", the taxpayer must also have received other property with a value equal to the excess. This follows from the presumption that all transfers are arms' length and that the amount realized with respect to each exchange group equals the value of the property transferred. This other property, or the "residual group," of necessity consists of property not of like kind or like class with any property that has been transferred and/or of property that cannot qualify for section 1031 treatment (e.g., cash or securities). Conversely, if the aggregate net value of the property received in all of the exchange groups exceeds the aggregate net value of the property transferred, it follows from the arms' length presumption that the taxpayer also transferred other property (again, a "residual group"). The regulation states, "In general, the residual group will consist of money or property transferred in the exchange or money or property received in the exchange, but not both." It . also provides that property in the residual group is considered to come first from Class I assets, second from Class II assets, third from Class III assets, and fourth from Class IV assets (within the meaning of Regulation section 1.1060-lT(d)), but that within each class, taxpayers can choose which assets are allocated to the residual group.

Comment; It would seem that the residual group could never consist of both property transferred and property received, so that the qualifying words "in general" are unnecessary. If there are circumstances in which the residual group consists of both property transferred and property received, it would be useful for the regulations to illustrate that with an example.

It is unclear whether the rule governing the classes from which the residual group is created serves any function. It does not affect the gain recognized by the taxpayer. Furthermore, since property in the residual group receives a fair market value basis, under section 1.1031(f)-l(c), and property that is not treated as part of the section 1031 exchange is governed by section 1001 (section 1.1031(f)-l(b)(3)(ii)) and also receives a fair market value basis, tax basis is not affected.

§ 1.1031(b)-l(c). Liabilities Incurred in Anticipation of an Exchange

Under existing rules, liabilities of which the taxpayer is relieved in the exchange may be offset by liabilities assumed by the taxpayer. The proposed regulations provide that any liability incurred by the taxpayer "in anticipation of" the exchange may not be offset by liabilities assumed in the exchange, i.e., relief from such liabilities will be treated as boot. This rule is characterized in the preamble to the proposed regulations as a "clarification" of existing law.

Comment; It is by no means clear to us that the proposed rule is merely a clarification of existing law. While an application for the step-transaction and substance-over-form doctrines could presumably be found in the section 1031 area, there appears to be no case squarely on point. There is a case which might be regarded as supporting a rule contrary to the one proposed, but it is distinguishable.[3] In Garcia, a party to the exchange increased the mortgage on his property on the eve of the exchange. The Tax Court held that netting was permitted, but the taxpayer before the court was not the party who increased the mortgage. On the other hand, there is dictum in another Tax Court case[4] which supports the proposed regulation. The only "authority" of which we are aware that is squarely on point is a private letter ruling issued in 1984.[5] Thus, it would appear to be stretching a point to characterize the proposed regulation as a clarification.

Moreover, we question whether the rule is warranted. For example, consider a taxpayer with an unencumbered property worth $100 who wishes to exchange it for a like kind property

[3] Garcia v. Commissioner. 80 T.C. 491 (1983).

[4] Behrens v. Commissioner. T.C. Memo. 1985-195

[5] PLR 8434015 (May 10, 1984).

worth $100 encumbered by a $30 liability. One way for the parties to equalize values for the exchange is for the other party to transfer $30 of cash in the exchange. Under the current rule, which prohibits the liabilities assumed from offsetting cash received, the taxpayer would have $30 of boot in the exchange. Another way to equalize values would be for the taxpayer to borrow $30 against his property. The proposed rule would deny netting in this case, thereby treating the taxpayer as receiving $30 of boot in this case also. Thus, the proposed rule serves as a backstop to the current rule prohibiting liabilities assumed from offsetting cash received.

As indicated elsewhere in this report, we question whether that rule is appropriate. The taxpayer could achieve the same economic result by causing the other party to repay the $30 of debt before the exchange (a third way of equalizing values) and then borrowing $30 against the property received in the exchange. We question whether a rule that has little practical effect but to cause taxpayers to restructure transactions in this way is either necessary or appropriate. In any case, we believe that the judicial doctrines mentioned above should be adequate to deal with any perceived abuses in this area. Accordingly, we recommend deletion of the proposed rule relating to liabilities incurred in anticipation of an exchange.

The proposed rule is so vague that it would be bound to spawn audit controversies and litigation. We therefore believe that if the rule is retained, some objective standard should be incorporated. For example, the rule could provide that (i) a liability would be treated as incurred in anticipation of the exchange if the liability was incurred less than 30 days before the other party was ####rst under a binding commitment to participate in the exchange and that (ii) a presumption that the liability was so incurred would arise if the liability was incurred either less than six months before consummation of the exchange or after negotiations with the other party to the exchange began.

In any event, we believe that the proposed rule should not apply where the taxpayer does not cash out any part of his investment as a result of incurring the liability (i.e., where the proceeds are invested in the property that is exchanged).