REPORT #665

TAX SECTION

New York State Bar Association

REPORT ON SECTION 1031 PROPOSED TREASURY REGULATIONS
RELATING TO DEFERRED LIKE-KIND EXCHANGES

August 3, 1990

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REPORT # 665

TAX SECTION

New York State Bar Association

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August 3, 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 deferred like-kind exchanges. The report was prepared by a Committee chaired by Henry M. Co.hn, Michael Hirschfeld and Victor P. Keen. The principal draftsmen were Michael Hirschfeld, Ronald A. Morris, Elliot Pisem, Warren Gleicher and Jeffrey M. Eisenberger.

First, let me say that we generally commend the Regulations as setting forth clear, concise rules that are easily administrable. Most of our comments address only technical issues.

Our report makes recommendations designed to clarify, simplify or better implement certain rules contained in the Regulations. Particularly, the report (a) suggests that various rules in the Regulations be made consistent with each other, (b) suggests alternatives to various rules in the Regulations, (c) illustrates that there may be some confusion as to the limits of the constructive receipt doctrine as applied in the deferred like-kind exchange context, (d) recommends that the installment sales rules apply in the deferred like-kind exchange context, (e) questions the regulation's definition of "related party," and (f) discusses the interaction of the Section 752 and Section 1031 Regulations.

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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 # 665

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 RELATING TO DEFERRED LIKE-KIND EXCHANGES

August 3, 1990

REPORT ON SECTION 1031 PROPOSED TREASURY REGULATIONS RELATING TO DEFERRED LIKE-KIND EXCHANGES

I. INTRODUCTION[1]

On May 16, 1990, the Internal Revenue Service (the "Service") promulgated proposed regulations under Section 1031[2] relating to deferred like-kind exchanges.

Section 1031 addresses the treatment of like-kind exchanges. Section 1031 (a) provides that no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged solely for property of a like-kind that is to be held either for productive use in a trade or business or for investment.

Prior to the Tax Reform Act of 1984, Section 1031 did not specifically require that a like-kind exchange be completed within a specified period of time in order to qualify for nonrecognition of gain or loss. In the absence of any statutory authority directly addressing the issue of deferred like-kind exchanges, the Ninth Circuit held, in Starker v. United States, 602 F.2d 1341 (9th Cir. 1979), that an exchange qualified for nonrecognition treatment under Section 1031 even though the property to be received

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[1] This report was prepared by a subcommittee of the Committee on Income from Real Property and the Committee on Personal Property, chaired during the preparation of this report by Henry M. Cohn, Michael Hirschfeld and Victor F. Keen. The report's principal authors were Michael Hirschfeld, Jeffrey M. Eisenberger, Warren Gleicher, Ronald A. Morris and Elliot Pisem. Helpful comments were received from Arthur A. Feder, Carolyn J. Ichel, Andrew Ratts, Marty Edelstein, Victor Keen, Ann-Elizabeth Purintun and others.

[2] unless otherwise indicated, Section references are to the Internal Revenue Code of 1986, as amended.

by the taxpayer could be designated up to five years after the initial transfer of property by the taxpayer and even though the taxpayer, could have ultimately received cash.

The Tax Reform Act of 1984 added Section 1031(a)(3), which served to limit the ability to effectuate deferred exchanges. Section 1031(a)(3) provides that any property received by the taxpayer in a deferred exchange is treated as property which is not like-kind property if:

(1) the property is not identified as property to be received in the exchange on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange, or

(2) the property is received after the earlier of (a) the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange or (b) the due date (including extensions) of the taxpayer's tax return for the taxable year in which the transfer of the relinquished property occurs.

The proposed regulations promulgated on May 16 added new Section 1.1031(a)-3 setting forth guidance as to these limitations on deferred exchanges and amended Section 1.1031(a)-l relating to the general requirements for exchanges under Section 1031. In particular, Section 1.1031(a)-3 offers guidance with respect to the following:

(1) the definition of a deferred exchange;

(2) the identification and receipt requirements of Section 1031(a)(3);

(3) the treatment of the receipt of money or other property in the case of a deferred exchange; and

(4) the computation of gain or loss recognized and the basis of property received in a deferred exchange.

II. SUMMARY OF COMMENTS OK PROPOSED REGULATIONS

We generally commend the proposed regulations as setting forth clear and concise rules that are easy to apply by both taxpayers in practice and the Service on audit. We also commend the regulations for setting forth rules that make it possible for the taxpayer to structure deferred exchanges free of overly technical and burdensome rules.

The vast majority of our comments address various technical issues although we acknowledge that most of these issues do not seriously inhibit the ability of taxpayers to properly structure deferred exchanges in reliance on these rules. However, we do note that while these regulations are prospective only (that is, they only apply to post July 2, 1990 transfers not subject to a preexisting binding contract), the Service may wish to permit taxpayers to elect to apply these rules to pre-publication transactions (that is, pre-July 3, 1990 transfers). This not only provides a consistent policy viewpoint but may also eliminate burdensome litigation relating to issues that, in the

Service's view, have ultimately been decided in the taxpayer's favor. We also would question whether the Service could prevail in a case where it took a position contrary to these regulations.

We do recognize that the proposed regulations take a liberal approach in establishing safe harbors for deferred like-kind exchanges. While the letter of credit and guaranty safe harbors are consistent with pre-regulation policies in other areas of the tax law, the safe harbors for qualified escrow funds and intermediaries protect situations that might well be construed to create constructive receipt under other pre-regulation guidelines. However, by providing these liberal safe harbors, we believe the Service is both recognizing the apparent liberal approach that Congress and the courts have taken towards deferred exchanges and also helping to facilitate exchanges in smaller transactions by taxpayers who could not afford the more elaborate and expensive structures that would otherwise be required if more stringent regulations were proposed. As a consequence, we believe the Service's approach here to be, on balance, commendable.

Our comments also express concern about the treatment of liabilities in a deferred exchange by a partnership. We recognize that this comment technically relates to Section 752. However, the interrelationship of Section 752 with the deferred exchange regulations does dictate the need for clarification either under Section 752, by proposed regulations or notice, or by appropriate comment under the Section 1031 regulations with suitable cross-references. in the Section 752 regulations. It is important to

promulgate regulations specifically addressing this point in order to eliminate the possibility for income recognition for any deferred exchange where a partnership transfers property subject to existing indebtedness or in which the buyer assumes such debt, and thereafter effectuates a deferred exchange which is free of tax under Section 1031.

Our most important technical comments with respect to the regulations include:

(1) Where more than one property is transferred, the identification and receipt requirement should be applied separately with respect to each property in all cases or, at a minimum, where there are contingencies beyond the taxpayer's control that prevent all properties from being transferred at the same time.

(2) The identification and receipt requirements should not be permitted to lapse on a Saturday, Sunday or legal holiday but rather should be extended to the next following business day.

(3) The three property safe harbor for the identification requirement should be applied separately with respect to each property transferred.

(4) The 200 percent safe harbor for the identification requirement should be applied with respect to the net value, as well as the gross value, of the identified properties.

(5) The treatment of real property under construction should also apply to personal property (such as airplanes or facilities) under production.

(6) Restatements of the doctrine of constructive receipt set forth in the regulations should be limited to eliminate any confusion as to its scope, which may otherwise arise due to the general liberal approach of the regulations towards use of qualified escrow funds and intermediaries.

(7) The restriction on the receipt of interest or a growth factor appears inconsistent with other provisions of the Internal Revenue Code and should be removed.

(8) Further clarification of the examples illustrating application of the safe harbors (namely, examples 3 and 4) would be appropriate.

(9) In the event of the occurrence of a "material and substantial contingency", the regulations should permit cash to be received both before and after the lapse of the 45 day identification period; the regulations now only permit receipt of cash after lapse of the 45 day identification period.

(10) The installment sale rules should be applied, to the fullest extent possible, in a manner consistent with the deferred exchange rules where "boot" is received in a deferred exchange or where property cannot be received in a deferred exchange and the taxpayer ultimately receives all cash. However, any attempts to use the deferred exchange rules to circumvent the general installment sale rules should be prevented.

(11) In view of the liberal safe harbors, we question the broad definition of related parties.

(12) The safe harbors should be made applicable to simultaneous like-kind exchanges.

III. DETAILED ANALYSIS OF PROPOSED REGULATIONS

Subsection (a) - Overview;

Proposed Income Tax Regulation Section 1.1031(a)-3(a) sets forth an overview of the proposed regulations.

Subsection (b) - Identification and Receipt Requirements: Summary:

Proposed Income Tax Regulation Section 1.1031(a)-3(b) generally provides that property received by a taxpayer will not be of "like kind" to property relinquished by the taxpayer in a "deferred exchange" if (i) the replacement property is not "identified" before the end of the "identification period," or (ii) the identified replacement property is not "received" before the end of the "exchange, period." The "identification period" commences on the day the taxpayer transfers the relinquished property and

ends 45 days thereafter. The "exchange period11 begins on the day the taxpayer transfers the relinquished property and ends on the earlier of (i) 180 days thereafter or (ii) the due date (including extensions) for the taxpayer's federal income tax return for the taxable year in which the transfer of the relinquished property occurs. For purposes of the above definitions, if the taxpayer transfers more than one property and the properties are transferred on different dates, the above periods are determined by reference to the earliest date on which any such property is transferred. Section 7503 is inapplicable to the above periods and, accordingly, the last day for performance can occur on a Saturday, Sunday or legal holiday.

Comment

Proposed Income Tax Regulation Section 1.1031 (a) -3 (b) requires that, where more than one property is transferred and such properties^ are transferred at different times, the identification and exchange periods commence on the earliest date that any of the relinquished properties are transferred. We believe that each transferred property should be separately treated for purposes of the commencement of the identification and exchange periods. At a minimum, however, we believe there should be an exception to this rule where contingencies "beyond the control" of the taxpayer (such as zoning approvals) prevent the taxpayer from transferring all the relinquished properties at the same time. In such a situation, the taxpayer should be permitted to treat each relinquished property as a separate property

for purposes of the identification and exchange period requirements.

We also believe that it is inappropriate to permit the last day for performance to occur on a Saturday, Sunday or legal holiday since business transactions are usually not completed on such days. This is inconsistent with the liberal approach taken in the regulations that attempt to make like-kind exchanges simple to implement. Thus, we believe it appropriate to adopt the Section 7503 standards. Compare Rev. Rul. 83-116, 1983-1 Cum. Bull. 264, with Snvder v. Comm'r, 41 TCM 1416 (1981).

Subsection(c) - Identification of Replacement Property Before The End of The Identification Period

summary

Proposed Income Tax Regulation Sections 1.1031(a)-3(c)(1) and (2) basically provide that a property will only be considered “identified” if it is designed as replacement property in a written document signed by the taxpayer and hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period to a person involved in the exchange other than the taxpayer or a "related party." Notwithstanding the above rule, if replacement property is received by the taxpayer before the end of the "identification period," the property will "in all events" be treated as "identified" before the end of such period.

Comment

We believe that the prohibition against giving the identification notice to a "related party" should not exist where the related party is, in fact, the person acquiring the transferred property in an otherwise valid like-kind exchange.

Summary

Proposed Income Tax Regulation Section 1.1031 (a)-3 (c) (3) provides that replacement property is "identified" only if it is "unambiguously described in a written document or agreement." This requirement is satisfied with respect to real property if such property is described by a legal description or street address and, with respect to personal property, if such property is described by a specific description of the particular type of property. As to the latter, the regulations provide the example of a truck being "unambiguously described" if it is described by a specific make, model and year.

Comment

We believe that a "distinguishable name" should be added to the list of "unambiguous descriptions" with respect to real property. For example, the "Empire State Building" or the "Plaza Hotel" should constitute an "unambiguous description" for an exchange property.

Summary

Proposed Income Tax Regulation Section 1.1031 (a) -3 (c) (4) permits the taxpayer to identify a maximum of three properties without regard to their "fair market values"

(defined below) (the "three property rule") or, alternatively, any number of properties as long as their aggregate "fair market value" as of the end of the identification period does not exceed 200 percent of the aggregate fair market value of all the relinquished properties as of the date such properties were transferred by the taxpayer (the "200 percent rule"). If an identification does not fall within either of the above parameters, the identification requirement will nevertheless be satisfied with respect to (i) any replacement property "received" by the taxpayer before the end of the identification period, and (ii) any replacement property identified before the end of the identification period and received before the end of the exchange period, provided that, for purposes of the latter exception, all the properties received under (i) and (ii) constitute at least 95 percent of the aggregate "fair market value" of all identified replacement properties (the "95 percent rule").

Proposed Income Tax Regulation Section 1.1031(a)-3(1) defines "fair market value" on a "gross basis" (i.e.. without regard to liabilities that encumber the property).

As an illustration of the three property and 200 percent rules, assume A transfers property X to B when X has a value of $100x. A in turn identifies properties C, D and E within the identification period, each having a gross fair market value of $100x. If A receives only property C within the exchange period, this exchange is valid under the three property rule. Alternatively, if A transfers property X for $100x and identifies properties C, D, E and F

as replacement properties, as long as the total value of the latter properties does not exceed $200x, A's exchange would constitute a valid like kind exchange even if he acquired only one or two of such properties within the exchange period.

As an illustration of the 95 percent and “receipt within identification period” rules, assume A transfers property X to B when X has a value of $100x. A in turn identifies properties c (value $160x), D (value $160x), E (value $160x) and F (value $20x). Within the identification period, A "receives" property c and, within the exchange period, A "receives" properties D and E. (Presumably, A paid additional cash to the extent the properties received had a value in excess of $100x or those properties were encumbered by debt in such amount.) Although the above identification does not satisfy either the three property or 200 percent rule, it is nevertheless valid under the proposed regulations. This is so (i) with respect to property C because, under Proposed Income Tax Regulation Section 1.1031(a)- 3(c)(4)(ii)(A), A "received" such property before the end of the identification period and (ii) with respect to properties D and E because, under Proposed Income Tax Regulations Section 1.1031(a)- 3 (c) (4) (ii) (B), the aggregate value of all identified properties "received" before the end of the exchange period ($480x) constitutes "at least 95 percent of the aggregate fair market value of all identified replacement properties" (i.e.. 95 percent of $500x, or $475x).

However, if in the above example, the aggregate fair market value of properties C, D, E and F remained at $500x but property F had a value of $3 Ox and that property was not acquired before the end of the exchange period, the identification would not be valid with respect to properties D and E because (i) the identification would fail the three property, 200 percent and 95 percent rules and (ii) the latter properties would not have been "received" before the end of the identification period.

Comment

We believe that the three property rule should be applied separately with respect to each property transferred. Such a rule would be consistent with the 200 percent rule (discussed below) which, although technically applied on an aggregate basis, is in fact contingent upon the total combined fair market values of the properties transferred. For example, if one property with a $10x fair market value is transferred, any number of properties with a total fair market value of $20x may be identified under the 200 percent rule. However, if two properties which each have a $10x fair market value are transferred, any number of properties with an aggregate fair market value of $4Ox may be identified under the above rule.

Additionally, we believe that "gross fair market value" should not be the only test .for purposes of the 200 percent rule. Properties to be received in an exchange are generally "matched" by reference to their net equity values(i e.. gross fair market value less liabilities that encumber the property), not their gross fair market values.

For example, if A transfers property X with a net value of $100x to B, B will have to invest $100x to acquire another property for A. B may then purchase property Y with a value of $150x subject to a mortgage of $50x to complete the exchange, since B would be expending only $100x to purchase the exchange property.

The proposed regulations ignore the net equity value of property and, consequently, they create anomalies for persons who acquire property subject to a mortgage. For example, assume that A transfers property X with a fair market value of $100x to B. Within the identification period, A identifies properties M, N, 0 and P, each having a gross fair market value of $6Ox and each subject to a mortgage of $35x (i.e. . each property has a net equity value of $25x) . Since B has $100x in cash, he may purchase all four of the properties and transfer them to A. However, this identification would fail both the three property rule and the 200 percent rule because A has designated four properties and the total gross fair market value of properties M, N, O and P ($240x) exceeds 200 percent of the value of X ($100x). We recognize that this exchange would still be valid since it satisfies the 95 percent of the fair market value of the identified properties test. However, if A instead receives properties M, N, and O but is unable to receive property P before the end of the exchange period, A will not have acquired 95 percent of the fair market value of the identified properties. Accordingly, if properties M, N and O were received after the identification period, none of the properties would qualify for "like kind"

exchange treatment under Section 1031, which clearly appears to be an unintended and not particularly sensible result.

In light of the foregoing, we propose that one of the following additional alternative tests be adopted in the proposed regulations:

(i) allow the 200 percent rule to be based on a comparison of (A) the lower of the fair market value or net equity value of the relinquished property (or properties) to (B) the lower of the fair market value or net equity value of the identified properties when identified; or

(ii) an alternative test to the three property, 200 percent and 95 percent rules that would provide for a valid identification where the net equity values of the replacement properties did not exceed 100 percent of the net equity value of the relinquished property (or properties). For this purpose, a slightly higher percentage (such as 120 percent) should be more appropriate to give some leeway due to value fluctuations that are likely to occur in any deferred exchange.

There may be concern that this proposal to utilize net fair market value could be abused since debt could be placed on the identified properties in anticipation of their acquisition, in order to bring excess identified properties within this rule. To address this concern, the regulations could provide that, for purposes of this net equity value test, any indebtedness placed on

an identified property in anticipation of the transfer to the taxpayer could be excluded from the computation of net equity value. For this purpose, a specified time period could be used to add certainty to this rule. For example, all indebtedness incurred within one year of the date of identification, excluding, however, bona fide purchase money indebtedness or construction financing, could be excluded. In any event, however, bona fide third party indebtedness that already encumbers the property and that is assumed, or taken subject to, in the exchange, should be deemed relevant in determining net equity value.

The above proposal can be illustrated by the following examples:

Alternative (i) Example: A transfers property X, with a value of $200x and subject to a mortgage of $100x, to B. Within the identification period, A identifies properties M, N, O and P, each having a value of $110x and each subject to a $60x mortgage, since the total gross values of the properties to be received (i.e.. $44Ox) exceeds 200 percent of the gross equity value of property X (i.e.. $200x), the identification would not be valid under the proposed regulations. However, since the total net equity of the properties to be received (i.e., $200x) does not exceed 200 percent of the net equity value of property X (i.e.. $100x), the identification would be valid under our proposal.

However, if the properties instead each had a value of $9Ox but were each subject to mortgages of only $30x, the identification would fail under our first and second additional proposals noted above because the net

equity value of the identified properties (i.e.. $240x) would exceed 200 percent of the net equity value of the relinquished property (i.e.. $100x), but would meet the.200 percent rule under the proposed regulations because the gross fair market value of the identified properties in the aggregate ($360x) would not exceed 200 percent of the gross fair market value of the relinquished property ($200x). For this reason, we reiterate that we do not wish to undercut the proposed regulations. but rather add additional alternative options.

Alternative (ii) Example; A transfers property X, with a net and gross value of $100x, to B. Within the identification period, A identifies properties M, N, 0 and P, each having a gross value of $60x and each being subject to a $35x mortgage. Although the identification is not valid under either the three property rule or 200 percent rule, the identification is valid under our proposal because the net equity value of the identified properties (i.e.. $100x) does not exceed 100 percent of the net equity value of X (i.e.. $100x).

We also believe that the proposed regulations should reflect the legislative history contained in the Conference Committee Report under P.L. 98-369 (H.R. Rep. No. 98-861, 98th Cong., 2d Sess. at 866 (1984)). The Conference Report states that "[i]t is anticipated that the [identification] requirement will be satisfied if the contract between the parties specifies a limited number of properties that may be transferred and the particular property to be transferred will be determined by contingencies beyond the

control of both parties. For example, if A transferred real estate in exchange for a promise by B to transfer property 1 to A if zoning changes are approved and property 2 if they are not, the exchange would qualify for like kind treatment.

"Based on this Report, it appears that there could be some additional exception, beyond the three property and 200 percent rules, for properties that are identified subject to a contingency beyond the control of both parties (such as zoning or environmental restrictions), provided that the value of the properties to be received in the event the contingency is not met does not exceed some specified percentage (such as 100 percent) of the net value of the relinquished property. Appropriate contingencies beyond the control of both parties might be limited to properties subject to governmental requirements such as zoning restrictions or removal of environmental restrictions.

To illustrate the above, assume that A transfers property X, with a value of $100x, to B on January 1, 1991. within the identification period, A identifies property Y worth $1!0x. However, A states (within the identification period) that if the local authorities will not allow Y to be zoned for residential purposes by April 1, 1991, he alternatively identifies properties M, N and O worth $100x in the aggregate. Under the above proposal, the identification would be valid because the value of the contingent properties would not exceed the value of the relinquished property although under the proposed regulations, this exchange would not qualify.

Summary

Proposed Income Tax Regulation Section 1.1031 (a) -3 (c) (5) provides a “de-minimis rule” for property which is "incidental to a. larger item of property." Such property is not treated as separate property for purposes of the above identification requirements if (i) in standard commercial transactions, the incidental property is typically transferred together with the larger property, and (ii) the aggregate fair market value of all incidental property does not exceed 15 percent of the aggregate fair market value of the larger property.

Comment

In light of the recently proposed Section 1031 personal property regulations (the "new proposed regulations") , the second prong of the above de minimis rule should be deleted. Accordingly, under our proposal, the rule would be that "incidental property" will not be treated as separate property for purposes of the identification requirements if such property is typically transferred together with a larger property in commercial transactions. This is so because such incidental property, when exchanged along with real property solely for real property, will in all events be treated as "boot" for Section 1031 purposes under the new proposed regulations.

Moreover, since the new proposed regulations provide for different classes of personal property which are not of "like kind" to each other, it is very likely that in many circumstances (particularly, with respect to exchanges of hotels) , the transfer of real property for

"like kind" real property will violate the three property rule. For example, the transfer of one hotel with "significant" personal property (i.e.. greater than 15 percent of the value of the hotel) for another hotel with a similar amount of personal property where the latter property falls within at least three different "classes" of property will violate the three property rule, because the hotel plus each class of personal property will be treated as a "separate property" for purposes of the three property rule. Thus, since the new proposed regulations would treat as "boot" any personal property received that was not of a "like kind" to the personal property relinquished, we believe that placing a quantitative limit on the amount of personal property that can be transferred without being treated as "separate property" for purposes of the identification requirement is unwarranted. Alternatively, if the Service believes a quantitative limit is neede, dwe would support inclusion of a 50% test similar to that set forth in Section 512(b)(3)(B)(i).

Summary

Proposed Income Tax Regulation Section 1.1031(a)-3(c)(6) provides that an identification of replacement property may be revoked at any time before the end of the "identification period" if the revocation is made in a written document signed by the taxpayer and delivered in the same manner as is required for the original identification notice under Section 1.1031(a)-3(c)(2),*supra*.

Comment

Since the rules relating to revocations of identification notices are consistent with those for sending such notices, we see no problem with this rule.

Subsection (d) - Receipt of Identified Replacement Property

Summary

Proposed Income Tax Regulation Section 1.1031 (a) -3 (d) provides that identified replacement property will be considered "received" before the end of the "exchange period" if the taxpayer receives the replacement property before the end of such period, and such property is "substantially the same property" as identified. If the taxpayer identifies more than one property as replacement property, the above rule will be applied separately with respect to each replacement property received.

Comment

The term "received" is used in Section 1031, but is not defined anywhere in the proposed regulations, or in Section 1031.: one might question whether the use of the term "received" requires that a taxpayer actually receive title to the replacement property. We do not believe that this is necessary; instead, the test should be whether, on or before the 180th day, the taxpayer becomes the owner, within the meaning of the Federal Income Tax Law, of property that is of like-kind to the relinquished property. For example, in Starker v. United States. 602 F.2d 1341 (9th Cir. 1979), the taxpayer received a third party's purchasers' rights to

the property and the right to possess the property. Such possession was considered "like kind" to a fee interest transferred.

In nonexchange cases, receiving the "benefits and burdens" of property has generally been deemed to constitute a transfer. For example, in Snider v. Comm'r. 453 F.2d 188 (5th Cir. 1972), an accrual basis taxpayer was deemed to have transferred his mill when he entered into a binding contract to transfer the mill and not when actual title was transferred. In that case, the buyer of the mill occupied the premises before title was transferred. In Merrill v. Comm'r. 40 TC 66 (1963), aff'd. 336 F.2d 771 (9th Cir. 1964), a taxpayer's holding period for property was held to commence when he received the benefits and burdens of ownership and not when legal title was transferred. In White v. Comm'r. 33 TCM 330 (1974), a transfer of property was deemed to occur through a land contract in which the purchaser issued an installment note and had the benefits and burdens of ownership even though the seller retained legal title to the premises as security for such note. Cf. Income Tax Regulation Section 1.337-2(a), which indicated a sale may occur if an executory contract has been entered into and the contract is not conditional. Cf. Rev. Rul. 54-607, 1954-2 C.B.177.

As indicated by the above discussion, the definitions of "transfer" and "receive" vary in different contexts. Thus, some definition of when property is "received" should be included in the proposed regulations. Based upon the above

authorities, property may be deemed received when the taxpayer holds a contract to purchase the property, takes possession and assumes the benefits and burdens of ownership of the property within the exchange period.

Subsection (e) - Special Rules for Identification and Receipt of Replacement Property to be Produced

Summary

Proposed Income Tax Regulation Section 1.1031(a)-3(e) generally provides that property not in existence or being produced at the time of identification can qualify as "replacement property," if the identification requirements discussed above are satisfied. The fair market value of replacement property that is to be produced is its estimated fair market value as of the date it is expected to be received by the taxpayer.

If "substantial changes" (i.e., changes other than variations due to usual or typical production changes) are made in the property to be produced after it has been identified, such property will not be considered to satisfy the "substantially same property" requirement of Section 1.1031(a)-3(d). Personal property to be produced as replacement property will not meet the "substantially same property" requirement unless production is completed on or before the date, such property is received by the taxpayer. However, real property to be produced as replacement property will meet the above requirement even if production is not completed on or before the date the taxpayer receives the property, provided that (i) the replacement

property received constitutes real property, and (ii) the replacement property received/ had production been completed on or before the date the taxpayer received the property, would have been considered to be “substantially the same property" as identified.

Notwithstanding the above rule with respect to replacement real property to be produced, any production occurring after the property is received by the taxpayer will not be treated as property of a "like kind" and, accordingly, will be treated as "boot" for purposes of Section 1031.

Comment

We believe that Proposed Income Tax Regulation Section 1.1031(a)-3(e) should treat personal property to be produced in a similar manner to that of real property to be produced. Accordingly, replacement personal property that is not completed on or before the date the taxpayer receives such property should nevertheless constitute "qualifying" replacement property if (i) the replacement property constitutes personal property, and (ii) the replacement property received, had production been completed on or before the date the taxpayer received the property, would have been considered to be "substantially the same property" as identified.

Additionally, provided that the replacement property is "substantially completed" when it is transferred to the taxpayer (in this regard, a quantitative test for "substantially completed" could be adopted, for example, 90 percent) , we believe that any minor finishing

work performed on the property after the 180th day should be disregarded and should not constitute "boot" for purposes of Section 1031. In such a case, it seems unfair to penalize a taxpayer who has complied with the identification and exchange requirements by requiring that such, taxpayer separately value and treat as "boot" the "minor" improvements, such as punch-list items, minor retesting and recalibrations, and similar work that is not finished within the ISO-day period.

Subsection (f) - Receipt of Money or Other Property

Paragraph (f) (1) - In general

Summary

Proposed Income Tax Regulation Section 1. 1031 (a) -3 (f) (1) deals with the effect of the receipt of money or property other than like-kind property on the qualification of an exchange under Section 1031. It begins by stating that the rule of the first sentence of Proposed Income Tax Regulation Section 1.1031 (a) - l(a) (2) — that Section 1031(a), which requires that a taxpayer receive solely like-kind property, does not apply to an exchange in which, as part of the consideration, the taxpayer receives money or other property (but that Sections 1031 (b) and (c) , which mandate partial recognition of gain and nonrecognition of loss, may apply if a portion of the consideration does consist of like-kind property)[3] — applies to deferred exchanges. It then states that, if, in a deferred exchange, the taxpayer actually or constructively

[3] 'A similar rule is found in existing Section 1.1031(a)-1(a).

receives money or other property before actual receipt of like kind replacement property, gain or loss may be recognized; if the money or other property actually or constructively received before actual receipt of like-kind replacement property is in the full amount of the consideration, the transaction will constitute a sale, rather than a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property.

Comment

The substance of this paragraph is clearly correct. However, we would suggest clarification so as to avoid an unwarranted inference from being drawn regarding the allowability of a loss in a deferred exchange governed by Section 1031(c). We suggest that:

1. The words "in which gain or loss will be recognized in full11 be added to the final sentence immediately following the word "sale".

2. Two additional sentences be added at the end of the paragraph reading: "By contrast, if the taxpayer actually or constructively receives money or other property less than the full amount of the consideration for the relinquished property before the taxpayer actually receives like-kind replacement property, the transaction may nevertheless constitute a deferred exchange described in Sections 1031 (b) and (c) , in which gain will be recognized to the extent of the amount of cash and fair market value of other property received, but loss will not be recognized. To the extent the taxpayer actually or constructively receives cash or other property, gain will be recognized under Section

1031(b), even though the taxpayer may ultimately receive like-kind replacement property in the full amount of the consideration."

Paragraph (f)(2) - Actual or constructive receipt

Summary

The proposed regulations describe the circumstances in which a taxpayer will be in actual or constructive receipt of money or property for purposes of Sections 1031 and 1.1031(a)-3. The general rules of this paragraph do not apply, however, to the extent that the taxpayer qualifies for a safe harbor under subsection (g).

The proposed regulations state that the determination of whether a taxpayer is in actual or constructive receipt of money or other property is made under general tax rules and without regard to the taxpayer's method of accounting. They then state that a taxpayer is in actual receipt of cash or other property when he actually receives it or receives the economic benefit of it; and that a taxpayer is in constructive receipt "at the time such money or other property is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time or so that the taxpayer can draw upon it if notice of intention to withdraw is given." This language very closely traces the first sentence of Income. Tax Regulation Section 1.451-2(a).

Although a taxpayer is not in constructive receipt if his control of the receipt is subject to substantial

limitations or restrictions (as provided in the second sentence of section 1.451- 2(a)), constructive receipt does occur when the limitations lapse, expire or are waived. An affirmative rule that constructive receipt occurs upon lapse, etc. of the limitations is not found in Section 1.451-2(3), although it is certainly consistent with case law under that provision. Miele v. Comm'r, 72 TC 284 (1984) . Paragraph (f)(2) does not itself define "substantial limitations or restrictions," but subparagraph (iii) of the example contained in paragraph (f)(3) suggests that limiting the taxpayer's right to
receive money or other property to a circumstance described in paragraph (g)(6) (such as a right to receive money after the end of the identification period, if the taxpayer has not identified replacement property before the end of the identification period) would constitute a substantial limitation. Actual or constructive receipt by an agent of the taxpayer "determined without regard to paragraph (k) of this section" also constitutes actual or constructive receipt by the taxpayer.

Comment

We agree with the view that, except as may be provided in safe harbors or other rules directed solely at deferred exchanges, the determination of whether actual or constructive receipt has occurred should be made under the general rules concerning actual and constructive receipt.[4] In this regard, a cross-reference to Section 1.451-2 would be

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[4] See our comments below concerning Proposed Income Tax Regulation Section 1.1031(a)-3(m), which seems to contradict paragraph (f) (2) in this regard.

appropriate; however, we question the necessity or desirability of restating, in somewhat modified form, the tests for constructive receipt contained in the accounting method regulations under Section 451. If any clarifications or modifications of general applicability to the general rules are needed, they should be proposed as amendments to the accounting method regulations. Modifications to the general rules having specific application to deferred exchanges should be clearly labeled as such. If a discussion of "substantial limitations and restrictions" is retained in paragraph (f)(2) , the substantive rule hidden in the example in paragraph (f) (3) -- that the circumstances described in paragraph (g)(6) are substantial limitations — should be stated explicitly in the operative portion of the regulation.

Paragraph (f)(3) - Example

Comments

The example is uncontroversial. It is useful in that it makes clear that a taxpayer who has constructively received cash proceeds, but ultimately receives like-kind replacement property, is treated as having purchased that property. We have commented above on the need for the premise of subparagraph (iii) of the example that the circumstances described in paragraph (g) (6) are "substantial limitations" to be made explicit in an operative provision.

We question one inference that might be drawn from the reference to paragraph (g.) (6) in paragraph (f) (3). By

reason of its incorporation of paragraph (g) (6), paragraph (f) (3) states that a substantial and material contingency that relates to the deferred exchange and is beyond the control of the taxpayer or a related party may be a "substantial limitation" for constructive receipt purposes. This suggests that other contingencies,, such as those within the control of a related party, will not be "substantial limitations." It is far from clear that this is a proper statement of the doctrine of constructive receipt as developed in other areas of the tax law. Hyland v. Comm'r. 175 F.2d 422 (2d Cir. 1949) (taxpayer owned more than 85% of stock of corporation that controlled payment), aff'a. 7 TCM 236 (1948). Paragraph (g)(6) does have an entirely proper role in limiting the contingencies which may be relied on for qualification for the special safe harbor provisions of the proposed regulations. It should be made clear, however, that, as applied to the general question of constructive receipt, paragraph (g)(6) is merely illustrative and that the existence of constructive receipt should be determined without regard to whether a contingency satisfies paragraph (g) (6)

Subsection (g) - Safe Harbors

Paragraph (g)(1) - In general

Summary

Proposed Income Tax Regulation Section 1.1031(a)-3(g)(1) introduces the statement of four "safe harbors" which describe circumstances that will not be taken into account in determining whether a taxpayer is in actual or constructive receipt of money or other property.

The safe harbors apply only until the taxpayer has the "ability or unrestricted right to receive money or other property." To the extent the taxpayer has such an ability or unrestricted right, the transaction does not qualify under Section 1031(a).

Comment

This brief paragraph is possibly the most confusing portion of Section 1.1031(a)-3, since the interaction between the presence or absence of constructive receipt, which involves a lack of substantial "restrictions" on the taxpayer's control of the receipt of money, and the presence or absence of an "ability or unrestricted right" to receive money is not clearly explained. For example, it is not clear whether a right to receive money that is limited to the circumstances described in paragraph (g)(6) is ipso facto not an "ability or unrestricted right."

We believe that paragraph (g)(1) could be simplified and clarified by referring explicitly to the rules set out in detail in paragraph (g)(6). Thus, the second and third sentences of paragraph (g)(1) should be amended to read: "However, even if a transaction is otherwise within the safe harbors, to the extent the taxpayer has a right to receive money or other property (or has a right to furnish a safe harbor arrangement and thereby receive money or other property) that is not limited to the circumstances described in paragraph (g)(6), the taxpayer may be in constructive receipt of such money and other property and the transfer of the relinquished property may not qualify for nonrecognition

of gain or loss under Section 1031(a). These safe harbors thus apply only until the taxpayer has a right that is not so limited."

We also believe that these regulatory safe harbors should be made applicable to simultaneous like-kind exchanges so as to eliminate the potential for tax. We do not, however, believe that the Service presently has the regulatory authority to apply these safe harbors or the general like-kind exchange rules where the taxpayer receives the like-kind property prior to the date on which the taxpayer transfers the property (so-called "reverse Starker transactions"). This we believe must be addressed by Congress if it is believed appropriate from a policy perspective.

Paragraph (a)(2) - Security or guarantee arrangements

Summary

The first safe harbor provides that whether constructive receipt of money or other property exists will be determined without reference to three specified security arrangements: (1) a mortgage, deed of trust, or other security interest in property (other than cash or a cash equivalent) ; (2) a standby letter of credit meeting requirements similar to those of Temporary Income Tax Regulation Section ISA.453-1(b)(3)(iii) ; or (3) a guarantee of a third party.

Comment

The provision is generally reasonable and appropriate (subject to the exception discussed below). In particular, it creates a commendable parity between the rules governing

installment sales set forth at Temporary Income Tax Regulation Section ISA.453-1(b)(3)(i) (relating to security interests and guarantees) and (iii) (relating to letters of credit and the like-kind exchange rules). It might be appropriate to provide examples of "cash equivalents" (such as bank certificates of deposit or Treasury notes) as is done in the installment sales regulation, or cross refer to those regulations. Apart from the foregoing, we also, believe that the paragraph (g) (6) time periods should override the general default provisions in the above instruments and, accordingly, rights under such instruments should not be enforceable until the consummation of the paragraph (g)(6) time periods in all events.

Paragraph (a)(3) - Qualified escrow accounts and qualified trusts

Summary

The second safe harbor provides that whether constructive receipt of money or other property exists will be determined without reference to the fact that the taxpayer's transferee's obligations are secured by cash (which would not qualify under the first safe harbor) , so long as the cash (or cash equivalent) is held in a "qualified escrow account" or "qualified trust." In order for an escrow account or trust to be "qualified," the escrow holder or trustee must not be the taxpayer or a related person (as defined in subsection (k)) and the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the amounts held in the escrow account

or trust must be limited to the circumstances described in paragraph (g)(6).

Comment

A substantial question exists as to whether this safe harbor undercuts the distinction that Congress and the courts have maintained between an exchange and a cash sale followed by reinvestment of the proceeds. As some cases have recognized, the distinction between the two situations is in many ways a purely formal one and a taxpayer who has complied with the formal requirements of Section 1031 should be entitled to its benefits. See, e.g., Barker v. Comm'r. 74 TC 555, 561 (1980). Nevertheless, those cases did not purport to undo the entire law of agency and the tax law principles applicable to it.

The definition of "related party" in subsection (k) appears to exclude a person who in fact acts as the taxpayer's agent, so long as the agent's services are restricted to exchanges intended to qualify under section 1031. Thus, under paragraph (g)(3), a person acting as the taxpayer's agent may be in actual receipt of cash, which he is then able to invest in other real property while acting as the taxpayer's agent, yet the taxpayer will still qualify for nonrecognition under Section 1031. We are concerned that this is an overly expansive rule having little, if any, support in the decided cases.

Apart from the foregoing, we also believe that if the taxpayer has the right to terminate the escrow or trust account prior to any of the enumerated events set forth in paragraph (g)(6) and take the cash (as contrasted with

appointing a replacement escrow agent or trustee in the event of, for example, gross negligence) then the arrangement should not be permissible. This should be clarified.

Paragraph (a) (4) - Qualified Intermediaries

Summary

The third safe harbor permits the person to whom the taxpayer transfers the relinquished property to be the taxpayer's agent, so long as the transferee is a "qualified intermediary" and the taxpayer ' s rights to receive money or other property from the intermediary are limited to the circumstances described in paragraph (g) (6). A "qualified intermediary" is defined as a person who is not the taxpayer or a related party and who, for a fee, acts to facilitate the exchange by acquiring the relinquished property from the taxpayer (either on its own behalf or as agent for another) , acquiring the replacement property (either on its own behalf or as agent for another) , and transferring the replacement property to the taxpayer.

Comment

The reference to the intermediary's not being the taxpayer in paragraph (g) (4) (ii) (A) seems superfluous. It is also difficult to comprehend why receipt of a fee should be a prerequisite to "qualified intermediary" status. Finally, the text of the regulations should make explicit the sanctioning of "directed deeds" which is stated inferentially in Example 3 of paragraph

(g) (7) and directly only in the "Explanation of Provisions" to the proposed regulations.

Paragraph (a)(5) - Interest and growth factors

Summary

The final safe harbor permits a taxpayer to receive an interest or growth factor with respect to the deferred exchange. However, the taxpayer's right to receive the interest or growth factor must be limited to the circumstances described in paragraph (g)(6).

Comment

The requirement that the interest or growth factor cannot be received except in the circumstances described in paragraph (g) (6) (i.e., generally after it is no longer possible for the taxpayer to receive like-kind property) is inconsistent with the general rules regarding accounting for interest payments. For example, Proposed Income Tax Regulation Section 1. 446-2 (d) (1) provides that accrued and unpaid interest is treated as having been paid before the allocation of any payments to principal. Cf. Proposed Income Tax Regulation Section 1. 127.2-1 (e) (2) (ii) (last sentence). Thus, any cash received before receipt of like-kind property is likely to be properly characterized as interest under general tax accounting principles. We do not perceive why receipt of such interest before receipt of like-kind property should have any impact whatsoever on the qualification of the exchange under Section 1031 provided that the parties clearly designate the payment as a payment of interest that has accrued through the date of such payment.

Paragraph (a)(6) - Additional restrictions on certain safe harbors

Summary

Proposed Income Tax Regulation Section 1.1031(a)-3(g)(6) provides the substantive conditions which determine whether certain (or, if our suggestion relating to paragraph (g)(1), above, is adopted, all) of the safe harbors apply. It provides that a taxpayer may not receive money or other property until one of four events has occurred:

(1) the end of the identification period if the taxpayer has not identified replacement property before the end of the identification period;

(2) the receipt by the taxpayer of all of the identified replacement property to which he is entitled;

(3) if the taxpayer has identified replacement property, the later of (a) the end of the identification period and (b) the occurrence of a material and substantial contingency that relates to the exchange, is provided for in writing, and is beyond the control of the taxpayer or a related party; and

(4) the end of the exchange period.

Comment

The thrust of paragraph (g) (6) seems to be that the taxpayer's right to receive money or other property must be deferred until it has become certain that the taxpayer will

not receive like-kind property qualifying for nonrecognition under Section 1031. Paragraph (g)(6)(iii) permits the receipt of cash after the end of the identification period but before the lapse of 180 days if there has occurred a "material and substantial contingency that

(A) Relates to the deferred exchange,

(B) Is provided for in writing; and

(C) Is beyond the control of the taxpayer or a related party (as defined in paragraph (k) of this Section)...."

We question whether the ability to receive cash under these very limited circumstances should be restricted to the period after the lapse of the 45-day identification period. We do note that there appears to be a clear policy goal to prohibit the receipt of cash during the identification period but we do not necessarily see a greater risk of constructive receipt before the lapse of the identification period as contrasted with after the identification period given the limited nature of the triggering event involved. (See also our comments relating to paragraphs (f)(2) and (g)(1) for a discussion of paragraph (g)(6) 's interaction therewith.)

We also note that these limitations only apply to a taxpayer's right to "receive" money. By contrast, in certain other safe harbor provisions, the limitations apply to the taxpayer's right to "receive, pledge, borrow or otherwise obtain the benefits of" the cash. Proposed Income Tax Regulation Sections 1.1031(a)- 3(g)(3)(ii)(B) , (iii)(B).

For consistency, these (g)(6)limitations should also be made applicable to all those enumerated items.

Paragraph (g) (7) - Examples

Comment

Examples 1 and 2 are uncontroversial. The juxtaposition of Examples 3 and 4 is presumably intended to illustrate the rather extreme line beyond which a "qualified intermediary11 transaction may not go. We are also somewhat confused by the factual predicate of Example 3(ii) — that "C acquires [sic] real property X from B." By reason of other facts stated in the Example, it is evident that C may be a qualified intermediary even though C at no point has either any of the benefits or burdens of ownership of the property (which is acquired by C subject to D's pre-existing right to purchase it at a fixed price5) or title to the property; thus, it would be inappropriate to describe C as an "acquirer". Evidently, the intent of the Example is to point out that B must contract directly with C, rather than merely directing the cash purchaser of B's property to remit funds to C; the Example should be clarified so that no inference is raised that C's "acquisition" has any substance beyond this under principles of either tax law or local property law.

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[5] The regulations do not appear to rely to any extent on the fact that C might be obligated to purchase the property from B even if D were to default on D's obligations under the May 1, 1991, contract.

Subsection (h) — Interest and Growth Factors

Summary

Proposed Income Tax Regulation Section 1.1031 (a) -3 (h) provides that if a taxpayer receives interest or a growth factor with respect to a deferred exchange, such interest or growth factor will be treated as interest, regardless of whether it is paid in cash or property.

Comment

We believe this approach is appropriate. Presumably, interest characterization applies to both the income and deduction sides.

Subsection (i) — Reserved

Subsection (j)-Determination of Gain or Loss Recognized and the Basis of Property Received in a Deferred Exchange

Comment

A most significant aspect of this proposed regulation is the reservation of regulations that will address the coordination with Section 453. We would expect that the installment sales rules will provide that any "boot" that is received is to be subject to installment sales treatment and only taxed when the cash proceeds are received by the taxpayer. We would hope that since the use of a qualified escrow fund or qualified intermediary is permitted in a like-kind exchange, the presence of such escrow fund or intermediary should not jeopardize the ability to utilize the installment sales rules with respect to a proposed

deferred exchange in which cash is ultimately received due to a failure to meet the identification or delivery requirements or in which part cash and part-like-kind property is received due to a failure to be able to identify sufficient properties or receive all designated properties in the exchange. While we recognize that policy may not dictate having these safe harbors be made applicable to all installment sales, we recognize that there is a need for a certain degree of consistency between these two provisions where a deferred exchange is intended but not fully consummated. However, any attempts to thus utilize the deferred exchange rules as a device to circumvent the general installment sales rules should be prevented.

We also believe that the interest charge rule of Section 453A should not apply to the extent proceeds are reinvested in like kind property. Since the identification period ends, at the latest, on the filing deadline for the tax return in which the transfer originally occurred, we do not believe this presents a problem where the identification and/or receipt periods span two years.

Subsection (k) - Definition of related party

Summary

Proposed Income Tax Regulation Section 1.1031(a)-3(k) defines the term "related party". A person is a related party if the person and the taxpayer bear a relationship described in either Section 267(b) or Section 707(b), using a "more than 10%" test in lieu of a "more than 50%" test.

A person is also a related party if the person acts as the taxpayer's "agent". A person may act as such an "agent" by performing services as the taxpayer's employee, attorney, or broker, but the performance of services with respect to exchanges of property intended to qualify under Section 1031 is not taken into account in determining whether a person is the taxpayer's agent.[6] Finally, a person is a related party if the person bears a relationship described in Section 267(b) or Section 707(b)[7] to the taxpayer's "agent" (i.e.. using a
10% test).

Comment

The subsection (k) definition of related party is crucial to the operation of the safe harbors. Unfortunately, it is difficult to discern (and the Explanation of Provisions provides no guidance concerning) why the proposed regulations, which are quite generous in many other respects, bar the use of the safe harbors in so many ways simply because a related party (other than one who is in fact the taxpayer's agent) is used as escrow holder, trustee, or intermediary or why they adopt so broad a definition of "related party," particularly when Section 1031(f), recently added to the Code to preclude abusive like-kind exchanges involving related persons, adopts a more narrow definition (by not reducing the 50% test of Section 267(b); see Section 1031(f)(3)).

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[6] The performance by a "financial institution" of "routine financial services" is also not taken into account. The quoted terms are not defined in the regulations, but perhaps they should be.

[7] Again substituting "10%" for 50%".

We also question the rule of paragraph (k) (2) (i) concerning the performance of services solely in connection with Section 1031 exchanges. There appears to be no reason to believe that an attorney engaged to perform services in connection with a series of like-kind exchanges will be any less subservient to the taxpayer than his regular attorney and, it seems to us, such a "Section 1031 lawyer" is more likely to be the taxpayer's agent in fact (under general principles of agency and tax law) in connection with the transaction. This difficulty points up the illogic of permitting a person who is in fact an agent to act as a qualified intermediary, but only so long as the agency is restricted to Section 1031 transactions.

In addition, we believe that further clarification is needed for the scope of subsection (k)(2)(i). For example, if an attorney acts as an intermediary, we believe that such attorney should not become a related party merely because his firm also does the real estate work or renders tax advice in connection with that transaction. Confirmation of this point may be appropriate. Lastly, we assume that a person who previously acted as the taxpayer's agent will not be deemed a related party. Perhaps a safe harbor should be specified so that if the person has .not performed services for the taxpayer within a specified period of time, for example, six months before the date of transfer then the person shall be deemed not to be the taxpayer's agent.

The proposed-regulations recognize that financial institutions can perform routine financial services for the

taxpayer and not be considered a related person. In a similar vein, consideration should be given to treating title insurance companies that routinely issue title insurance policies or conduct real estate closings, and other persons that do similar types of routine transactions, as not related to the taxpayer.

Subsection (l) — Definition of Fair Market Value

This subsection's caption accurately describes its content.

subsection (m) - No inference with respect to actual or constructive receipt rules outside of section 1031

This subsection's caption accurately describes its content.

Comment

As noted in our discussion of paragraph (f) (2), that paragraph (which relates to the concept of constructive receipt outside the scope of the safe harbors) seems to-contradict this subsection. Perhaps the intent is that the safe harbors, which are phrased in terms of whether certain facts are taken into account in determining whether there has been constructive receipt, are not to be looked to outside of Section 1031. We have no objection to such a rule and, if it is what was intended, the rule should be made explicit.

Subsection (n) - Effective Date Summary

This subsection provides that these rules generally apply to transfers of property made by a taxpayer after July 2, 1990 (subject to certain exceptions for written binding contracts).

Comment

Consideration should be given to permitting taxpayers to apply these regulations with respect to transfers made on or before July 2, 1990. In view of the liberal approach taken by the proposed regulations, elective use of these regulations for pre-July 3, 1990 transfers would permit certain taxpayers to terminate litigation with the Service where the litigation involves issues directly addressed by the regulations. Nonetheless, in view of both the limited resources of the Service and the limited precedential value such cases will have assuming the proposed regulations are adopted in final form, we would consider it appropriate for the Service to consider permitting this election and thus eliminating litigation on matters that the Service has openly concluded, on a global basis, should be decided in taxpayer's favor. This is particularly so since the Service stands little chance of prevailing in such cases once the proposed regulations become final.

IV. ADDITIONAL COMMENTS REGARDING DEFERRED EXCHANGES

Section 1031 and the regulations thereunder permit a "netting" of liabilities in computing the amount of gain to be recognized on a like-kind exchange. Only the excess of consideration received in the form of assumption of

liabilities over consideration given in that form is treated as money or other property. Income Tax Regulation Section 1.1031(b)-l(c). The proposed regulations apply this rule as well in the case of deferred exchanges. See Proposed Income Tax Regulation Section 1.1031(a)-3(j)(3), Example 5. Unfortunately, when the property being transferred in a deferred exchange is owned by a partnership, a question arises whether the liability netting rule of Section 1031 may be vitiated by the occurrence of a deemed distribution to the partners under Section 752 of the Code.

In the case of a simultaneous exchange in which the partnership transferor assumes liabilities at least equal in amount to those encumbering the transferred property, it does not appear that Section 752 would apply to create a deemed distribution, since at no point in time is there a reduction in the partners' respective shares of the liabilities of the partnership. For example, in Revenue Ruling 79-205, 1979-2 Cum. Bull. 255, the Service held that all liability adjustments (increases under Section 752(a) and decreases under Section 752(b)) "will be treated as occurring simultaneously, rather than occurring in a particular order" in the case of simultaneous nonliquidating distributions of partnership property to two partners. This rule of "netting" for purposes of Section 752 is now incorporated in Temporary Income Tax Regulation Section 1.752-lT(j)(3) in the case of increases and decreases resulting from a "single transaction."

The examples currently provided by Section 1.752-1T (j) (3) deal only with simultaneous increases and decreases. Nevertheless, we believe that it is appropriate to treat a deferred exchange as a "single transaction" for purposes of Section 1.752-1T (j)(3), regardless of whether the exchange property is acquired in the taxable year in which the taxpayer's property is transferred or in the subsequent taxable year, because the receipt of exchange property is pursuant to a single agreement and is the completion of a single transaction. Accordingly, we recommend that Section 1.752-1T (j) (3) be amended to make clear that gain is not realized to the partners by reason of a deemed distribution in the amount of the liabilities encumbering the transferred property, except to the extent that, under Section 1031, it is ultimately determined that the taxpayer is to be treated as having received money or other property by reason of a net decrease in liabilities. Such a rule will avoid the creation of unjustifiable distinctions between partnerships exchanging mortgaged property under Section 1031 and all other taxpayers.

It has been suggested by some that no clarifying amendment to Section 1.752-1T(j)(3) is needed, because the "single transaction" language in that section can, should, and will be read expansively by the Service. While we agree with an expansive reading as a matter of policy, we suggest that taxpayers will hesitate to rely on an expansive interpretation of the Section 752 Regulations that is neither incorporated nor suggested in subsequent Section 1031 Regulations.

Such hesitancy will be reinforced by the factual similarity of many deferred exchanges to the situation described in Revenue Ruling 81-242, 1981-2 Cum. Bull. 147. That ruling, which was promulgated several years before the issuance of the Section 752 Proposed Regulations, involved a Section 1033 transaction in which a partnership's reinvestment of condemnation proceeds was viewed as a "separate transaction" from the condemnation for purposes of applying Section 752. We understand that individuals inside and outside the Service have taken the position that Revenue Ruling 81-242 is distinguishable from a deferred Section 1031 exchange. We agree that a reinvestment of cash proceeds — even a reinvestment governed by Section 1033 — is, in its nature, a more "separate" transaction from that of the disposition of the taxpayer's property than is a deferred exchange which meets the exacting timing standards enacted by Congress in 1984.

Nevertheless, as long as Revenue Ruling 81-242 is outstanding and the regulations fail to provide a different rule for deferred exchanges, taxpayers will very properly be reluctant to assume that the "simple transaction" rule applies to deferred exchanges.