

TITLE ISSUES

OPEN ISSUES AFTER THE FINAL REGULATIONS UNDER INTERNAL REVENUE CODE SECTION 1031

It is interesting to reflect for a moment upon the changes made in the administration of the nation's tax policy over the last several years. When the Treasury Department issued regulations designed to implement changes made by the 1986 Tax Reform Act with respect to investment in real estate, they were severely criticized for what most practitioners thought were extremely technical and complex regulations. For example, the regulations defining passive activities are so complex that they may be, in many cases, disregarded by practitioners frustrated by their complexity. Stung by public criticism, the Internal Revenue Service under then Commissioner Fred T. Goldberg began publicly to adopt the theme of simplification in regulation projects under way in 1990 and 1991. Examples of this change in philosophy are both the Final Regulations on Multi-Asset Exchanges issued in March, 1991 and the Final Regulations on Deferred Exchanges issued in May, 1991. Both of these regulations, rather than attempting to answer every potential concern, instead attempt to provide "bright line" tests or "safe harbors" giving most taxpayers clear rules for determining the income tax consequences of various transactions. The Multi-Asset Regulations under section 1031 provide two "bright line" tests for determining when depreciable, tangible, personal property will be considered like-kind. The first test utilizes 13 general business asset classes created by Revenue Procedure 87-56. The second test utilizes product classes as published in the Standard Industrial Classification "SIC" Manual. Using these regulations most taxpayers will be able to determine with certainty what types of personal property will be considered like-kind under Section 1031. The Deferred Exchange Regulations likewise provide taxpayers with "safe harbors" which may be utilized in structuring and securing delayed exchanges. Those regulations state in their preamble that exchanges structured in a manner which does not fall within one or more of the safe harbors will not automatically be disqualified but will be carefully scrutinized. While the Internal Revenue Service is to be commended for achieving in large part its stated goal of simplification with the issuance of these regulations, the trade-off is that there remain a number of open issues under Section 1031 for which further guidance is necessary. This article will discuss the remaining open issues and, where possible, propose solutions.

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Assignment of Cash Deposit by Taxpayer to Qualified Intermediary

This issue often arises in two different situations: (i) the taxpayer has entered into a contract for sale of his property and the buyer has placed an earnest money deposit into a bona-fide escrow or (ii) the taxpayer has entered into a contract for the sale of his property and the buyer has given an earnest money deposit to the taxpayer who has a legally binding obligation to return the deposit if the sale does not close. The author assumes in both cases that the earnest money deposit would be treated as a "deposit" for federal income tax purposes.

The first situation is relatively straightforward and should not result in constructive receipt by the taxpayer. There is a significant amount of authority holding that a taxpayer/seller is not in constructive receipt of earnest money deposits held by an escrow agent in connection with the sale of property. See e.g. *Johnston v. Commissioner*, 14 T.C. 560 (1950).

The second situation presents a somewhat more complex issue because the Section 1031 regulations literally provide that a taxpayer will be considered to have received boot if he is in actual receipt of cash. Reg. Section 1.1031(k) - 1(f)(1). Nevertheless, the law is clear that no taxable event occurs as a result of a seller of property receiving an earnest money deposit, at least where there is a legal obligation to return the deposit to the purchaser if the transaction does not close (for reasons other than the default of the purchaser). See e.g., *Baird v. United States* 65 F.2d 911, 12 AFTR 896 (5th Cir. 1933), cert. denied, 290 US 690. Given such analogous authority, the IRS could conclude that under such circumstances the receipt by the taxpayer of the deposit does not result in actual or constructive receipt for purpose of Reg. Section 1.1031(k)-1(f). See also LTR 8118014 (Jan. 30, 1981). Since the literal words of the new Section 1031 regulations might imply that *any* receipt of cash constitutes boot, this clarification may have to be made by way of an amendment to the regulations.

Ability of Trustee or Intermediary to Resign and Ability of Taxpayer to Replace Trustee or Intermediary

There are numerous circumstances under which the trustee or intermediary may wish (or be compelled) to resign (e.g., conflict of interest, dispute over fees, etc.). There may also be circumstances where the taxpayer may want the trustee or intermediary to resign (e.g., inadequate performance, bankruptcy, breach of duty, etc.). It is common practice to allow the trustee, for example, to resign, or to give the grantor or beneficiary of the trust the ability to force the trustee to resign, provided, in either case, the grantor or beneficiary cannot appoint himself or any related person as a successor trustee.

The question here is to what extent may the resignation of the trustee or intermediary cause a disqualification of the safe harbor. It seems logical that the trustee or intermediary must, for any of the reasons stated above, have the ability to resign. This should not affect the qualification under the safe harbor, provided that under the documentation a successor trustee or intermediary must be appointed by the resigning trustee or intermediary, or perhaps even by the taxpayer, as long as the successor trustee or intermediary may not be a “disqualified person” as defined in Reg. 1.1031 (k)-1(k).

Necessity to Withhold Under Section 1445 in a Deferred Exchange

Section 1.1445-2(d)(2) provides that withholding under Section 1445 (FIRPTA) is not required if a non-recognition provision is applicable and the transferor provided notice of such applicability within 20 days of his transfer. In connection with a deferred exchange a taxpayer may not have even identified exchange property by the 20th day and therefore may only be able to provide a statement of intent. This is entirely consistent with Section 1.1445-9T of the regulations which provides a similar approach with regard to non-recognition under Section 1034 of the Code, and should also be applicable under a Section 1031 transaction.

Parameters of the Goodwill Prohibition Under Section 1.1031(a)-2(c)(2) of the Regulations on Multi-Asset Exchanges

The multi-asset regulations provide that goodwill and going concern value of one business can never be like-kind to the goodwill and going concern value of another business. It is logical to assume that the prohibition does not extend to other intangibles whose values reflect goodwill such as trademarks, trade names, customer lists, etc. but there is no guarantee that the service would not contest such an allocation. The validity of the rule that goodwill or going concern value of one business can never be like-kind to the goodwill or going concern value of another business is somewhat doubtful,

especially in light of current legislative proposals that would allow the retroactive amortization of goodwill and other intangibles, and is probably a strong candidate for litigation.

Placing Debt on Property Prior to an Exchange

The proposed multi-asset regulations provided that a mortgage placed on property “in anticipation of” disposing of the property in a Section 1031 exchange would be considered boot and cause recognition of gain. This prohibition was considered a “clarification” when it was included in the proposed regulations yet was deleted from the final regulations, causing great uncertainty. In other sections of the tax code, placing debt on property prior to its disposition will defeat an otherwise qualifying non-recognition transaction. For example, if a taxpayer structures an installment sale under Section 453 and immediately prior to transferring the property places a mortgage on the property, thereby effectively removing his equity, he will be denied installment treatment and gain will be recognizable in the year in which the mortgage proceeds were received. When comments were requested on the proposed clarification, the author argued at the public hearing that the words “in anticipation of” should be substituted by a clear period of time, perhaps one year, but this issue remains unresolved. Until further guidance is issued, it is probably wise to delay placing new financing on property until the tax year after the exchange has been completed.

Partnerships and Corporations

Under Section 1031(a)(1) the property transferred by the taxpayer must be “held for productive use in a trade or business or for investment” and the property received by the taxpayer must also be “held either for productive use in a trade or business or for investment”. Some of the issues raised by this provision are illustrated in *Bolker v. Commissioner* 760 F.2d 1039 (9th Cir. 1985) and *Magneson v. Commissioner* 753 F.2d 1490 (9th Cir. 1985). In *Bolker* the taxpayer’s wholly owned corporation liquidated, distributing property to him which he then exchanged with an unrelated party. The issue in *Bolker* was whether the taxpayer met the holding period requirement for the relinquished property. In *Magneson*, the taxpayer first exchanged property under Section 1031, and then contributed the replacement property to a partnership in exchange for a general partner interest under section 721. The primary issue in *Magneson* was whether the taxpayer met the holding period requirement for the replacement property. Although both these cases were decided in favor of the taxpayer, the service is still litigating these issues. (See e.g. *Maloney v. Commissioner* 93 T.C. 89 (1989) (taxpayer prevailed). Also see *Chase v. Commissioner*, 92 T.C. 816 (1989) (service prevailed)). In response to *Magneson* the service now has the additional argument that the taxpayer exchanged his real property for a partnership interest, an exchange to which Section 1031 no longer applies. However, in a “reverse-Magneson” transaction in which the

taxpayer receives a distribution of property from a partnership and then exchanges the distributed property in a Section 1031 exchange, the taxpayer may argue that he is deemed under Section 735 (b) to have held the distributed property for the period during which it was held by the partnership. The 1990 Tax Act amended Section 1031(a)(2) to provide that the exclusion of partnership interests would not apply to a partnership that has in effect a valid election under Section 761(a) to be excluded from the application of subchapter K. Owners of tenancy in common interests wishing to take advantage of the Section 761(a) election may discover that its scope is quite narrow. The co-tenants must not actively conduct a trade or business (e.g. manage the property). The issues presented by these cases, as well as the question of how long the taxpayer must hold the properties to meet the holding requirement, are not yet fully resolved.

Fragmentation

Another open issue is whether an exchange may be fragmented into two or more smaller exchanges or into one or more exchanges and one or more purchases. A taxpayer may wish to fragment an exchange to defer recognition of gain due to the allocation of excess assumed liabilities in a multiple asset exchange. There is analogous authority allowing fragmentation at least where the properties were not acquired by the taxpayer as part of the same transaction, are not necessarily inter-dependent, and could be used separately. In *Sayre v. United States*, 1 AFTR 2d 2035 (S.D. W.Va 1958) the taxpayer transferred farm land and a residence for other farm land and cash, some of which the taxpayer later used to purchase another residence under the predecessor of Section 1034. The taxpayer matched land with land and the cash with the residence, reporting the land for land exchange as a like-kind exchange without boot. The IRS found a deficiency on the ground that the cash and the land received should have been allocated between the assets given up. The court rejected this allocation approach. In Rev. Ruling 68-13 the IRS indicated that it would respect the allocation of a down payment to a particular asset if the allocation was stated in the contract of sale and resulted from bona-fide negotiations, suggesting that a sale can be fragmented. It is expected that the service will address the fragmentation issue in future pronouncements. Having created a regulatory structure dependent upon matching assets in order to maximize gain in many instances, the service will probably resist efforts by taxpayers to fragment their exchange transactions.

Coordination with Section 752

Further guidance is necessary on the coordination of the deferred exchange rules with Internal Revenue Code Section 752. The primary issue is whether increases and decreases in a partner's share of liabilities in a Section 1031 exchange may be netted for purposes of Section 752, notwithstanding that for purposes of Section 1031, liabilities assumed by the taxpayer

(or liabilities encumbering property transferred to the taxpayer) may offset liabilities assumed by the transferee (or liabilities encumbering property transferred by the taxpayer). In final regulations issued on December 23, 1991, the service provided that liabilities must be netted for purposes of Section 752 if the increase and decrease in the partner's share of partnership liabilities occur "as a result of a single transaction". It is not entirely clear whether a deferred exchange is such a "single transaction", particularly because of contrary analogous authority under Section 1033.

Expenses and Fees Incurred in a Multi-Party Deferred Exchange

In a typical multi-party deferred exchange the expenses and fees incurred by the taxpayer may include the following: Attorneys' fees in connection with structuring the exchange; attorneys' fees in connection with the transfer of the properties and the closings; accountants' fees; brokers' fees for the property transferred and/or acquired; mortgage fees; appraisal fees; intermediary fees; trustee fees. To what extent can these fees be used to offset boot received in the exchange?

Parties to a Section 1031 exchange who receive boot will recognize gain to the extent of the lesser of the realized gain or the boot received under IRC Section 1031(b). Realized gain is the excess of the amount realized over the adjusted basis of the property transferred. The amount realized in an exchange equals the sum of the fair market value of property received, cash received, and liabilities assumed by the other party. Non-deductible expenses typically are subtracted, along with adjusted basis from the amount realized in capital transactions to determine realized gain.

The regulations indicate that boot may take the form of nonqualifying real or personal property, cash, or relief from a liability. In an exchange in which each party either assumes a liability or transfers property subject to a liability, boot is determined by offsetting the liabilities. The party who is relieved of a greater liability than that which he assumes pursuant to the exchange is deemed to receive boot equal to the difference between the two amounts. Example #2 of regulation section 1.1031 (d)-2 provides some further guidance with respect to netting cash paid or received in an exchange and concludes that the taxpayer (D) is not permitted to offset the excess liability he assumes on a replacement property against cash received. This example is the only authority which the IRS cites in Rev. Ruling 72-456 in support of its conclusion that money paid for brokerage commissions may offset money received by a party to a section 1031 exchange for purposes of computing both realized and recognized gain.

The list of costs which could conceivably fall within the scope of Rev. Ruling 72-456 is potentially very lengthy. Expenses of consummating an exchange under Section 1031 may include brokerage commissions, fees to escrow agents,

title search and other legal fees, commissions, advertising expenses, appraisal fees, transfer taxes, recording fees, title insurance, surveyors' fees, costs of preparing property for sale, and many others. The IRS has indicated that the scope of the ruling is not limited to brokerage commissions. The ruling itself interprets example #2 in the regulations as standing for the apparently general principal that "money paid out in connection with an exchange under Section 1031" may be offset against cash received. The General Counsel's Memorandum issued in connection with Rev. Rul. 72-456 determined that there was no significant difference between cash paid to the other party to the exchange in example #2 of the Regulations and cash paid to the broker in the Ruling because in both cases money was paid "to consummate the exchange." The Memorandum concluded that the difference in identity of the payee "is not meaningful." Finally, the IRS ruled in Private Letter Ruling 8145100 that, consistent with example #2 and Revenue Ruling 72-456, the taxpayer could reduce his boot or realized gain on a Section 1031 exchange of real estate by his "selling expenses" but did not identify the specific expenses incurred. Further clarification from the service is needed in order for taxpayers to understand where the line will be drawn.

Reverse-Starkers

In *Edward C. Lee*, T.C. memo 1985-294 the taxpayers purchased a farm in November 1977. In June 1978, the taxpayers sold 5 parcels to 5 different purchasers and directed the sale proceeds be transferred directly to the seller of the farm. The Tax Court held that the sale of the 5 parcels did not qualify for non-recognition under Code Section 1031 because there was no evidence that the purchase and sales were interdependent parts of an overall plan to exchange properties.

In *Garbis S. Bezdjian v. Commissioner* 845 F.2d 217 (9th Cir. 1988) the taxpayer made an offer to purchase a gas station they operated under a lease. The seller refused to accept a rental property owned by the taxpayer in exchange. The taxpayers purchased the gas station and 3 weeks later sold the rental property to an unrelated party. Under these facts, the 9th Circuit affirmed the Tax Court in holding that there was no exchange qualifying for non-recognition under Section 1031.

In *Bernie D. Rutherford*, T.C. memo 1978-505, Wardlaw transferred 12 half-blood heifers to Rutherford on November 13, 1973. Their exchange agreement provided that Rutherford would transfer 12 three-quarter blood heifers to Wardlaw during 1974, 1975 and 1976. The agreement contained no provision for Rutherford to pay money to Wardlaw in the event he did not deliver the 12 three-quarter blood heifers. Under these facts, the Tax Court held that, as to Rutherford, the transaction constituted a non-taxable exchange under Code Section 1031(a). Note: If the cattle had been of different genders, they would not have been "like-kind".

The final regulations define a deferred exchange as one in which the taxpayer transfers property and subsequently receives qualifying property in an exchange. Comments were solicited in the proposed regulations on whether a "reverse-starker" transaction should qualify for tax deferral under Section 1031. The service indicated that the comments it received ranged from advocating the application of the provisions of Section 1031(a)(3) to reverse-starkers, to the view that Section 1031(a)(1) does not apply to these transactions. For the present, the service has settled on a determination that both the deferred exchange rules of Section 1031(a)(3) and the final deferred exchange regulations do not apply to reverse-starker transactions. The service indicated, however, that it will continue to "study" the applicability of the general rule of Section 1031(a)(1) to these transactions.

On the one hand, Internal Revenue Code Section 1031(a)(3) does not address the transactions and may have been intended to be the exclusive statutory provision governing non-simultaneous exchanges. On the other hand, the language of Section 1031(a)(1) does not suggest that it was intended in any manner to exclude reverse-starker exchanges. It is also not clear why, as a policy matter, reverse-starker exchanges should be excluded from coverage under Section 1031. In any event, the service's reservation on this issue has an ominous ring and taxpayers considering a reverse-starker should take into account the strong possibility of a challenge. One way to avoid structuring an exchange as a reverse-starker is for the taxpayer to obtain a leasehold interest in the replacement property. Options to purchase or exchange may also be acquired so long as the taxpayer is not treated as acquiring the property for tax purposes.

Taxation of Interest Income

The final regulations on deferred exchanges at 1.1031(k)-1(g)(5) provide that interest or a "growth factor" must be treated as interest and included in income according to the taxpayers' method of accounting. However, the regulations do not address the proper manner for reporting interest income earned on money held in a qualified trust or qualified escrow account. The service indicated that it planned to issue regulations under Section 468B(g), "Qualified Settlement Funds", including treatment of interest earned on deferred exchanges. The recently published proposed regulations under Code Section 468(B)(g), in fact, failed to address this issue and it is therefore unclear as to how the information reporting should work. For example, if the exchange is facilitated by an intermediary, it is unclear whether the financial institution should send the form 1099-INT to the intermediary or to the ultimate recipient of the interest. Presumably, the intermediary would be entitled to an interest deduction if it receives the form 1099 from the financial institution and then issues a matching 1099 to the taxpayer, but this also is unclear. The author argued at the public hearing on May 27, 1992 that it

should be permissible for the financial institution to send the form 1099-INT directly to the person entitled under the exchange agreement to the interest earned on the exchange balance. The issues surrounding reporting of interest income in a 1031 exchange assume greater importance when the relinquished property is transferred in year one, proceeds are invested by an intermediary with a financial institution, and replacement property is acquired in year two.

Coordination With Installment Sales

The service also plans to issue proposed regulations coordinating the deferred exchange regulations with the installment sale rules. At issue here are the appropriate methods of computing gain and basis, and the timing of that gain. The same issues exist but are perhaps less complicated in a simultaneous exchange in which the taxpayer receives a note as boot. For example, should a qualified escrow account or a qualified trust be disregarded in determining whether a taxpayer's receipt of an installment obligation constitutes a payment of boot? If the exchange straddles two years, in which year should the boot be recognized? At what time should the qualified trust no longer be disregarded? Should the answer to this question be different if the exchange fails and the taxpayer never receives replacement property?

If the taxpayer transfers relinquished property to a qualified intermediary and receives boot in the form of an installment obligation, should the transferee of the qualified intermediary be treated as acquiring the property for purposes of Section 453? If so, the taxpayer will recognize no gain at the time of the transfer of the relinquished property. To reach this result under the installment sale rules, the intermediary would have to be treated as the taxpayer's agent, a treatment not inconsistent with the deemed acquisition of both the relinquished property and the replacement property by the intermediary under the final regulations.

Land Trust

Section 1031(a)(2) denies non-recognition to the transfer or receipt of certain types of property including "Certificates of Trust or Beneficial Interests", and there is considerable uncertainty whether this exclusion applies to the interest of a

beneficiary in a land trust. A Revenue Ruling has been requested to clarify this issue and, unfortunately, the Ruling has not yet been issued. The service could conclude that the exclusionary language of Section 1031 does not apply to a land trust because for federal income tax purposes a land trust is a grantor trust and the beneficiary is treated as the owner of the property.

In order to minimize the risk that the exchange will be disallowed if the relinquished property were held in a land trust, many practitioners have advised their clients that the land trustee should be instructed to convey legal title from the trustee to the beneficiary prior to entering into a contract to sell or exchange that property. While this may appear to dispose of the issue, it must be remembered that Section 1031 also requires that "property be held either for productive use in a trade or business or for investment". This statutory requirement infers a "holding period" which applies both to the relinquished property as well as the replacement property. If one assumes that the interest of the beneficiary in a land trust is in fact excluded property under Section 1031, and the ownership is adjusted by conveying out of trust, there is some risk that the transaction will fail to meet the holding period requirement under Section 1031. Presumably, this would not preclude, although it may impinge upon, the taxpayer's ability to argue that the beneficial interest in the land trust was not excluded property in the first place.

As should now be readily apparent there remain a number of unresolved issues as well as significant traps for the unwary in planning 1031 exchanges. Although the final regulations resolve many broad issues, certain positions taken by the IRS seem likely to result in litigation, and it may take some time before many of these issues are settled. The quality and extent of IRS audits of Section 1031 exchanges are likely to increase, which should accelerate the resolution of some of the remaining issues.