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An Analysis of Proposed Regulations on Delayed Section 1031 Exchanges

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NOTE

AN ANALYSIS OF PROPOSED REGULATIONS ON DELAYED SECTION 1031 EXCHANGES

INTRODUCTION

Under the Internal Revenue Code of 1986,[1] gains from the sale or exchange of property are recognized and taxable except "as otherwise provided" in the Internal Revenue Code.[2] One of several exceptions[3] applies to gains realized on the exchange of property held for productive use or investment.[4]

Section 1001 of the Internal Revenue Code of 1986 provides that the sale or exchange of property is a taxable event and any gain or loss from that sale or exchange must be recognized for tax purposes in the year in which the property is transferred. Except as provided in section 1031, whether the taxpayer intends to or actually does use the proceeds of that transfer to acquire another property is irrelevant.

Section 1031, however, allows[5] a taxpayer to defer[6] taxes on the gain (or loss) in the value of property held for productive use or investment so long as the taxpayer exchanges that property for similar property which the taxpayer also intends to hold for productive use or investment. Thus, a taxpayer who intends to sell property used in his business or held for investment and to reinvest those proceeds in another property can, by properly structuring the transaction as an exchange, avoid paying taxes on any gain realized in the value of the relinquished

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1. I.R.C. §§ 1-9602, *amended by* the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

2. I.R.C. § 1001(c). "Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized." *Id.*

3. *See* I.R.C. § 1032 (exchange of stock for property); § 1033 (involuntary conversions); § 1034 (rollover of gain on sale of principal residence); § 1035 (certain exchanges of insurance policies); § 1036 (stock for stock of same corporation); § 1038 (certain reacquisitions of real property); § 1039 (certain sales of low-income housing projects); § 1040 (transfer of certain farm, etc., real property); § 1041 (transfers of property between spouses or incident to divorce).

4. I.R.C. § 1031(a) (1). "No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment." *Id.*

5. Case law, however, indicates that section 1031 nonrecognition of gain or loss on the exchange of like-kind property held for productive use or investment is mandatory, not optional. *See, e.g.,* United States v. Vardine, 305 F.2d 60, 66 (2d Cir. 1962). Although a taxpayer can choose to structure a transaction to qualify for section 1031 treatment, once he does so he must defer his tax liability. He is not then free to have the transaction treated as a taxable sale.

6. Transactions under section 1031 are often referred to as "tax-free" exchanges. This is a misnomer. While realizing gains on the sale of property that never get recognized is technically possible (*see* I.R.C. § 1014, basis of property acquired from a decedent), as a practical matter, taxes on the gains on the relinquished property are merely deferred. Any gain realized on the relinquished property must be used to adjust the basis in the replacement property (*see* I.R.C. § 1031(d)) and will be recognized on the sale of that property (unless it too is exchanged pursuant to section 1031).

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property.[7]

When the predecessor to section 1031 was first enacted in the Revenue Act of 1921,[8] Congress apparently had in mind the case of two parties, each having property the other wanted, bartering an exchange of the properties.[9] Since then, however, creative taxpayers have expanded the scope of section 1031 to cover transactions never envisioned by the Congress that created the tax deferred exchange. Finally, in the now famous *Starker* case,[10] the Ninth Circuit Court of Appeals found an exchange where the taxpayer did not receive replacement property until almost two years after transferring the relinquished property.

Thus, *Starker* established the concept of the delayed exchange.[11] In the prototype example[12] of such an exchange, the taxpayer transfers the relinquished property to another, called an accommodator, who then sells the property to a buyer. Sometime after the initial sale, the accommodator uses the proceeds of the sale to purchase property the taxpayer ultimately wants to hold. When this replacement property is purchased, it is concurrently deeded to the taxpayer.

Responding to a number of actual and perceived problems with the *Starker* precedent,[13] Congress added section 1031(a)(3) to the Internal Revenue Code in 1984.[14] This provision established specific tests that a delayed transaction must meet to qualify for non-recognition treatment under section 1031. However, there were two problems with the legislation. First, the new provision raised as many questions as it answered. Second, the new section did not resolve several other issues raised in *Starker* and by creative taxpayers pursuing section 1031 treatment for their transactions since *Starker*.[15]

Thus, in May 1990, the Internal Revenue Service ("the Service") issued proposed regulations amending Title 26 Code of Federal Regulations 1-103(a)-1

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7. For purposes of this Note and to avoid confusion, the terminology with respect to the property involved in exchange transactions will generally parallel that used in the proposed regulations. *See* Prop. Treas. Reg. § 1.1031(a)-3, 55 Fed. Reg. 20,278, 20,282 (1990). Accordingly, the property held by the taxpayer before the exchange will be referred to as the "relinquished property" and the property held by the taxpayer after the exchange will be referred to as the "replacement property."

8. Revenue Act of 1921, ch. 136, § 202(c), 42 Stat. 230 (1921).

9. *See* Levine, *Taxfree Exchanges Under Section 1031*, Tax Mgmt. (BNA) Portfolio No. 61-5th, at A-1 (1987) [hereinafter Levine].

10. Starker v. United States, 602 F.2d 1341 (9th Cir. 1979) (*"Starker III"*), *aff'g in part and rev'g in part* Starker v. United States, 432 F. Supp. 864 (D. Or. 1977) (*"Starker II"*).

11. The kind of exchange that, in principle, was established in *Starker* is often referred to as a "deferred exchange." Indeed, the proposed regulations that are the subject of this Note also refer to such exchanges as "deferred." Prop. Treas. Reg. § 1.1031(a)-3, 55 Fed. Reg. 20,282-285 (1990). For purposes of this Note, however, the term "delayed" will be used in reference to such exchanges. This is to avoid confusion with the term "tax-deferred exchanges" which refers to all section 1031 exchanges, not just the type defined by *Starker* and I.R.C. § 1031(a) (3).

12. *See* Section I.C., *infra*, for a more complete discussion of the mechanics of a delayed exchange.

13. *See* Section I.B., *infra*.

14. I.R.C. § 1031(a)(3), Tax Reform Act of 1984, Pub. L. No. 98-369, § 77, 98 Stat. 494 (1984).

15. *See* Section II, *infra*, for a discussion of these two problems.

and adding Title 26 Code of Federal Regulations 1.103(a)-3.[16] The purpose of these regulations was to implement section 77 of the Tax Reform Act of 1984 and to provide guidance to taxpayers concerning several other previously unresolved issues affecting delayed exchange transactions.[17]

The purpose of this Note is to analyze the proposed regulations in light of both congressional intent and prevailing industry practices. Analysis is important because exchanges in general and delayed exchanges in particular have become the primary means through which real estate investors are able to sustain their investments without reduction for taxes paid.[18] By preserving capital for investment, non-recognition treatment of gains on relinquished property in delayed exchanges directly affects the level of activity of real estate transactions and the quantum of funds invested.[19] To the extent the regulations are inconsistent with congressional intent or fail reasonably to consider prevailing industry practices (so as to restrict unduly the availability of delayed exchanges), they may have a substantial impact on economic activity.[20]

This Note focuses solely on the applicability of section 1031 to delayed exchanges as set forth in section 1031(a)(3) of the Internal Revenue Code and the proposed regulations. Thus, the Note is not a treatise on tax-deferred exchanges in general.[21] Also, while section 1031 applies to any property used in a trade or business or held for investment, the most widespread use of the delayed exchange is in real estate investments. Accordingly, this Note will focus primarily on delayed exchanges of real estate investments.

I. HISTORY AND BACKGROUND

This Section briefly describes the history of section 1031 of the Internal Revenue Code in general (Subsection A) and section 1031(a)(3)[22] in particular (Subsection B). As background for the analysis presented in Section II, this Section also describes the role delayed exchanges play in the real estate

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16. Department of the Treasury, Notice of Proposed Rulemaking, Like-kind Exchanges–Limitations on Deferred Exchanges; and Inapplicability of Section 1031 to Exchanges of Partnership Interests, 55 Fed. Reg. 20,278 (1990).

17. *Id.* at 20,279.

18. L. Weller, Section 1031 Lives: Like-Kind Exchanges and the Topsy Turvy World of Tax Legislation 1 (materials presented at the Third Annual Conference on Section 1031 Real Estate Exchanges (Los Angeles, Cal. June 25-26, 1990) (available at California Western School of Law, Law Review office) [hereinafter Weller].

19. *See* W. Wasserman, Mr. Mogul's Perpetual Search for Tax Deferral: Techniques and Questions Involving Section 1031 Like-Kind Exchanges in a World of Changing Tax Alternatives 5 n.4 (paper presented at the Third Annual Conference on Section 1031 Real Estate Exchanges (Los Angeles, Cal. June 25-26, 1990) (revised version of article published in 65 TAXES 975 (1987)) [hereinafter Wasserman].

20. *Id.*

21. *See* Levine, *supra* note 9, at A-1; 3 J. MERTENS, THE LAW OF FEDERAL INCOME TAX §§ 20B.01-20B.56 (1990), for a comprehensive treatment of section 1031 exchanges. For an extremely useful and practical guide to section 1031 exchanges, see Wasserman, *supra* note 19.

22. For the history of section 1031, see Note, *Nonsimultaneous Like-Kind Exchanges Under Section 1031 of the Internal Revenue Code*, 56 TEX. L. REV. 1271 (1978) [hereinafter Note].

marketplace (Subsection C) and the technical mechanics of structuring delayed exchanges of real estate (Subsection D).

A. History of Delayed Section 1031 Exchanges

The concept of non-recognition of gains on exchanges of property was first embodied in the Revenue Act of 1921.[23] After amendments in 1923 and 1924, the statute remained essentially unchanged until 1984.[24] Although Congress apparently had in mind barter transactions in enacting this provision, such transactions rarely arise in practice.[25] Thus, the case law leading up to *Starker* and the enactment of section 1031(a)(3) is a history of how the courts, creative taxpayers, and the Service gradually expanded the concept of the exchange for purposes of deferring taxes on gains from the disposition of property.

One of the first steps in that evolution was to recognize that more than two parties could be involved in a tax-deferred exchange. In this situation, the taxpayer has property which he wishes to sell (or a buyer who wishes to buy) but is reluctant to sell because of the tax consequences. The taxpayer may, however, be willing to exchange the property pursuant to section 1031. If either the buyer or the taxpayer is sufficiently motivated, another property suitable for exchange will be found. The buyer of the relinquished property, the seller of the replacement property and the taxpayer then structure a single transaction whereby the two properties are exchanged. If properly structured, the transaction results in (1) the taxpayer holding title to the replacement property, (2) the buyer holding title to the taxpayer's relinquished property, and (3) the seller holding cash (which ultimately comes from the buyer, the taxpayer, or both). This type of transaction was first approved in *Mercantile v. Commissioner*[26] in 1935.

An important variant on this type of transaction (and one which accords with the actual facts of *Mercantile*) is the four-party exchange. In the four-party exchange, a neutral fourth party is interposed among the other parties to accommodate the transaction. To effect the exchange, the following steps all occur simultaneously. First, the accommodator takes title to the replacement

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23. Revenue Act of 1921, ch. 136, § 202(c), 42 Stat. 230 (1921) provided in part:

> (c) For the purposes of this title, on an exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value; but even if the property received in exchange has a readily realizable market value, no gain or loss shall be recognized–
>
> (1) When any such property held for investment, or for productive use in trade or business (not including stock-in-trade or other property held primarily for sale), is exchanged for property of a like kind or use;
>
> . . . .

Id.

24. Levine, *supra* note 9, at A-1.

25. Note, *supra* note 22, at 1274.

26. Mercantile Trust Co. v. Commissioner, 32 B.T.A. 82 (1935).

property from the seller and exchanges it with the taxpayer for the taxpayer's property. The accommodator then transfers title in the taxpayer's property to the buyer for cash. Finally, the accommodator transfers the cash (and additional cash which may be deposited by the taxpayer) to the seller.[27]

In *Mercantile*, the court focused on both the intent of the taxpayer and the result of the transaction in holding that the transaction qualified under section 1031.[28] The principle enunciated in *Mercantile* is that a party, including a neutral party with no stake or risk in the outcome of the transaction, may take title to property solely for the purpose of exchanging it with the taxpayer so long as the ultimate result is an exchange.[29]

In *Garcia v. Commissioner*,[30] the Tax Court established standards which, if followed, would result in a transaction qualifying under section 1031.[31] In all these cases, however, the exchange of properties was simultaneous. That is, the relinquished property and the replacement property were exchanged concurrently in one integrated transaction notwithstanding the number of parties involved.

A close reading of many of the litigated cases reveals that at the outset there is a taxpayer and a willing buyer for the taxpayer's property, but no replacement property or seller.[32] The taxpayer and/or the buyer then have to locate a seller of replacement property. When a seller of replacement property is located,

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27. In *Mercantile*, the accommodator was a title company which effected all the required transfers of property and cash but received in exchange only its fees for processing the transactions. Again, the taxpayer ended up with the replacement property, the buyer with the relinquished property, and the seller with cash. *Id.* Variations of the multi-party model of a section 1031 exchange have been litigated many times. *See, e.g.*, Coupe v. Commissioner, 52 T.C. 394 (1969) (attorney as accommodator); Biggs v. Commissioner, 69 T.C. 905 (1978) (title company); J.H. Baird Publishing Co. v. Commissioner, 39 T.C. 608 (1962) (real estate agent); Barker v. Commissioner, 74 T.C. 555 (1980) (buyer); Brauer v. Commissioner, 74 T.C. 1134 (1980) (buyer).

28. *Mercantile*, 32 B.T.A. at 87.

29. *See also* Alderson v. Commissioner, 317 F.2d 790, 795 (9th Cir. 1963), *rev'g on other grounds* Alderson v. Commissioner, 38 T.C. 215 (1962). Typically an accommodator takes title to either property solely for the purpose of effecting the exchange. The accommodator does not usually assume the benefits and burdens (such as the usual market risk of fluctuations in the market value of the property) attending ownership and, thus, has no stake or risk in the outcome of the transaction. The Service argued that the accommodator is thus a "straw man," acting as nothing more than an agent of the taxpayer. Therefore, the Service argued, the underlying substance of a transaction involving an accommodator is a sale and concurrent repurchase, not an exchange under section 1031. The courts in *Mercantile* and *Alderson* held that where the taxpayers evidence an intent to exchange and the form of the transaction effected such exchange, the fact that the accommodator never assumed the benefits and burdens of ownership is not dispositive. *Mercantile*, 32 B.T.A. at 87; *Alderson*, 317 F.2d at 795.

30. Garcia v. Commissioner, 80 T.C. 491 (1983).

31. Those standards are that taxpayers desire:

> to effect a section 1031 exchange, their actions [are] consistent with that expressed intent, the conditions required to effect that intent [are] met, the contracts providing for the necessary series of transfers [are] interdependent, no cash proceeds from the sale of the original property [are] actually or constructively received by the [taxpayers], and, when the dust [is] settled . . . an integrated plan for an exchange of like-kind property was conceived and implemented.

Id. at 503.

32. *See* cases cited *supra* note 27.

contracts are executed and the transaction structured so as to qualify for section 1031 treatment.

It was only a small step, then, for T.J. Starker to avoid the inevitable scrambling to obtain replacement property before transferring the relinquished property to Crown Zellerbach.[33] In *Starker*, the taxpayer, his son, and his daughter-in-law agreed to convey timberland to Crown Zellerbach Corp. ("Crown") in return for Crown's promise to convey like-kind property within five years. Over the five years, Crown agreed to maintain "exchange value credits" on its books equal to the value of the timberland, less the value of property conveyed to the Starkers plus a 6% annual "growth factor" on the unused balance. If, after the five years, there was an outstanding balance of exchange credits, Crown was to pay the balance to the Starkers in cash. Over the next two years, Crown purchased twelve parcels selected by Starker and conveyed them to the Starkers (and others) on the Starkers' instructions. The value of the property conveyed to the Starkers exactly equalled the exchange value credits, so no cash was actually paid to the taxpayer.[34] Thus, the delayed exchange was born.

B. Legislative History of Section 1031(a)(3)

Conceptually, the Internal Revenue Code is dichotomous. A transaction involving relinquishment of one property and acquisition of a replacement property is either a sale/repurchase or an exchange, but not both. If the transaction is a sale/repurchase, the gain on the sale transaction is taxable. If the transaction is an exchange, however, the gain is not taxable at the time of the transfer. Instead, the gain on the increase in value of the relinquished property is deferred by adjusting the basis in the replacement property downward.

There is a strong bias in the Internal Revenue Code for construing a particular transaction as a sale/repurchase rather than as an exchange.[35] Competing with that bias, however, are the policies behind section 1031. One policy is that, where a taxpayer has only a theoretical gain in the increase in value of the relinquished property and continues his investment in like-kind property, requiring the taxpayer to recognize that gain for tax purposes is inequitable.[36] Another policy behind section 1031 is to relieve the Service of the administrative

33. *Starker III*, 602 F.2d 1341 (9th Cir. 1979). *See also* Starker v. United States, 432 F. Supp. 864 (D. Or. 1977) ("*Starker II*"); Starker v. United States, 75-1 U.S. Tax Cas. (CCH) 9,443 (D. Or. 1975) ("*Starker I*").

34. *Starker III*, 602 F.2d at 1343.

35. *See, e.g.*, Treas. Reg. 1.1002-1 (1990).

36. This rationale is similar, conceptually, to the rationale that gain not realized is also not recognized for tax purposes. *See* I.R.C. § 1001(b). Such gains include, for example, the "paper" increase in fair market value of property over the basis in that property which is not "realized" until it is the subject of a sale transaction. The rationale of section 1031 is that even though the exchange transaction is an otherwise proper basis for establishing a realized gain, by continuing the investment, the taxpayer has realized nothing tangible in the way of cash. His gain is still "on paper" in the new investment.

burden required to detect and evaluate potentially thousands of exchange transactions that occur every year.[37]

In practice, particular transactions do not fit neatly into one of the two categories. Where the exchange is a direct swap of property for property, the policies behind section 1031 are probably served. For example, in such a transaction no cash is generated with which to pay taxes. Congress recognized, however, that in the cases of multi-party and delayed exchanges, the rationale for non-recognition becomes more tenuous.[38] In these transactions, cash is generated but held by third parties to purchase replacement property.

Thus, in considering changes to the Internal Revenue Code in 1984, Congress expressed several concerns about section 1031. First, Congress was particularly concerned about the delayed exchange, especially under the facts of *Starker*.[39] In response, Congress simply drew the line on the facts of *Starker* declaring that "[t]he committee believes that like-kind exchange treatment is inappropriate in such situations and that the general rule requiring recognition of gain on sales or exchanges of property should apply. . . ."[40]

Second, Congress was concerned about the potential effect of combining the installment sale rules with the delayed exchange rule (as stated in *Starker*).[41] By combining these rules, delaying taxes on the gain in value of the relinquished property almost indefinitely was theoretically possible.[42] In particular, though not explicitly considered by Congress, the combination of these rules allowed a taxpayer tremendous flexibility to determine when, if at all, a gain on the exchange of the relinquished property would be taxable.[43]

Third, Congress was concerned about the administrative difficulties attending

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37. *See* Levine, *supra* note 9, at A-1; Biggs v. Commissioner, 69 T.C. 905, 913 (1978); H.R. REP. No. 432, 98th Cong., 2d Sess. 1231, *reprinted in* 1984 U.S. CODE CONG. & ADMIN. NEWS 697, 895.

38. H.R. REP. NO. 432, *supra* note 37, at 896.

> The special treatment of like-kind exchanges has been justified on the grounds that a taxpayer making a like-kind exchange has received property similar to the property relinquished and therefore has not effectively 'realized' a profit on the transaction. This rationale is less applicable in the case of [delayed] exchanges. To the extent that the taxpayer is able to defer completion of the transaction–often retaining the right to designate the property to be received at some future point–the transaction begins to resemble less a like-kind exchange and more a sale of one property followed, at some future point, by a purchase of a second property or properties.

Id.

39. *Id.*

40. *Id.*

41. *Id.* at 897.

42. *Id.*

43. For example, under the facts of *Starker III*, if T.J. Starker never designated any replacement property, he would have received cash five years after Crown took title to the timberland. If the taxpayer then elected to receive the cash in an installment sale under I.R.C. section 453, he could have paid tax on the gain in year five and/or as many years after in which he received cash from Crown, thus deferring taxes far into the future.

Starker-like delayed exchanges.[44] By combining the installment sale rules and a delayed exchange, years could theoretically pass before the basis in the various properties could be determined for purposes of determining tax liabilities.[45]

Thus, in 1984, Congress added section 1031(a)(3) to the Internal Revenue Code in section 77 of the Tax Reform Act of 1984.[46] The new section 1031(a)(3) provided that the gain on delayed exchanges would not be recognized for tax purposes only if the taxpayer complied with the specific provisions of the section. Those provisions required: (1) the taxpayer to identify the replacement property within forty-five days; and (2) actually to receive the replacement property within 180 days after transferring the relinquished property, or by the due date of the taxpayer's return with regard to extensions, whichever occurred first.[47] Thus, Congress directly addressed its concerns by severely restricting the circumstances under which a taxpayer could delay paying taxes on the gain from the transfer of property in a delayed exchange.

More significantly, however, this new section established previously lacking statutory authority for the delayed exchange and embodied Congress' explicit intent that such exchanges should be accorded non-recognition treatment so long as the requirements of section 1031(a)(3) were satisfied. Arguably, even more significant was the fact that in the wholesale restructuring of the Internal Revenue Code carried out in 1986, section 1031(a)(3) remained virtually untouched. While Congress curtailed or eliminated several longstanding Internal

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44. H.R. REP. No. 432, *supra* note 37, at 896.

45. *Id.*

46. *See* I.R.C. § 1031(a)(3), *added by* Tax Reform Act of 1984, Pub. L. No. 98-369, § 77, 98 Stat. 494 (1984). The provisions of I.R.C. § 1031(a)(3), *amended by* Tax Reform Act of 1986, Pub. L. No. 99-514, § 1805(d), 100 Stat. 2085, 2810 (1986), are:

> (3) Requirement that property be identified and that exchange be completed not more than 180 days after transfer of exchanged property.
>
> For purposes of this subsection, any property received by the taxpayer shall be treated as property which is not like-kind property if–
>
> (A) such 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
>
> (B) such property is received after the earlier of
>
> (i) the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or
>
> (ii) the due date (determined with regard to extension) for the transferor's return of the tax imposed by this chapter for the taxable year in which the transfer of the relinquished property occurs.

Id.

47. *Id.*

Revenue Code provisions favorable to property investors,[48] Congress made only one technical amendment to section 1031(a)(3),[49] thus affirming Congress' intent that delayed exchanges be available.

C. Delayed Exchanges in the Real Estate Market

Since *Starker*, exchanges in general, and delayed exchanges in particular, enjoyed widespread use as devices for real estate investors to defer taxes on property they wished to dispose of.[50] Exchanges have become even more important since passage of the Tax Reform Act of 1986 which eliminated the tax preference for capital gains.[51]

The typical investor in real estate has several objectives. One objective is to maximize wealth. Ultimately, the real estate investor seeks to maximize his net worth by investing in properties which appreciate in value at a rate consistent with his assumed risk. To accomplish this goal, the investor invests as little of his own funds as possible. By so doing, the investor also maximizes the appreciation in value of the property as a function of his invested capital.[52] As the investment matures, however, the rate at which the investor's wealth increases declines.[53] Thus, to maximize his wealth, the investor has to reinvest the gains in similar property.[54]

As long as a particular type of investment maximizes the investor's wealth, he has an incentive to continue that investment. The investor will change investments only when he can better maximize his wealth in the alternative investment. Real estate is widely perceived as an excellent investment and has

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48. For example, Congress eliminated the tax preference for capital gains which was a significant benefit to property investors. I.R.C. § 1202, *repealed by* Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 301-302, 100 Stat. 2085, 2216 (1986).

49. *See* I.R.C. § 1031(a)(3), *amended by* Tax Reform Act of 1986 Pub. L. No. 99-514, § 1805(d), 100 Stat. 2085, 2810 (1986).

50. Weller, *supra* note 18, at 1. Before reading this section, it may be helpful to review Section I.D., *infra*, for the mechanics of how a delayed exchange of real estate is structured.

51. I.R.C. § 1202, *repealed by* Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 301-302, 100 Stat. 2085, 2216 (1986).

52. For example, consider an investor who invests $10,000 in a property which costs $100,000 and borrows the remainder. The investor's wealth is increased by 100% when the property itself increases in value to $110,000 over the next year. Thus, an investor who has *only* $10,000 to invest maximizes his wealth by leveraging his property as much as possible.

53. Taking the example discussed in note 52, at the beginning of the second year, the investor's investment is now $20,000 (the original $10,000 plus the gain of $10,000 in the first year). Thus, in the second year, the rate of increase in the taxpayer's investment decreases to only 50% if the property increases in value another $10,000 ($10,000/$20,000 invested).

54. Again using the example in discussed in notes 52 and 53, the taxpayer has two options (not considering tax effects). First, he could take the gain in value of the property out of the property (by getting a second trust, for example) and reinvesting the gain in a second property also costing $100,000. Or, he could dispose of the first property and reinvest the proceeds ($20,000) in a second property. In either case, the taxpayer controls $200,000 worth of property and a 10% increase in the value of that property in the second year translates into the same rate of gain as in the first year.

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many features particularly favorable to wealth maximization.[55] Thus, it is not surprising that real estate investors tend to keep their funds invested in real estate rather than cashing out or investing in other types of investments.

Complementing the wealth maximizing objective is the desire to maximize the availability of funds for investment. To the extent those funds are diminished, particularly by tax policies, the taxpayer's ability to maximize his investment is also diminished.[56] In this context, the role of section 1031 is very important. In substance, section 1031 removes tax consequences as a factor in the investment decisions of real estate investors. Through proper structuring of an exchange meeting the requirements of section 1031, the investor maximizes his wealth by realizing and reinvesting the gains in relinquished property without diminishing of the funds available for reinvestment.

As an important variant of exchanges in general, the delayed exchange conforms to a number of practical realities investors face in trying to structure tax-deferred transactions. The new section 1031(a)(3) goes beyond the underlying policies of section 1031 to recognize and respond to those realities, significantly expanding the applicability of tax deferral in real estate transactions.

One practical reality is that the conflicting needs and interests of taxpayers, buyers (of the relinquished property), and sellers (of the replacement property) rarely coincide. Usually the buyer, having alternative investment opportunities, wants to buy and has no incentive to wait around for the taxpayer to find replacement property. The seller, on the other hand, wants to sell. He too, has little incentive to accommodate the taxpayer with the myriad details involved in structuring an exchange.

The delayed exchange is an ideal mechanism for resolving these conflicts. Through the delayed exchange mechanism, the taxpayer can conclude the transaction with the buyer without concern for the second transaction with the seller. After the first transaction is concluded, the taxpayer is then free to pursue acquiring the replacement property without concern for the details of transferring the relinquished property. The delayed exchange transaction is indeed, as Congress recognized, more like a sale and repurchase than a true exchange.[57]

Section 1031(a)(3) responds to the realities of the marketplace in another increasingly important situation—the multiple property exchange. Most of the situations discussed above, assume that only two properties are exchanged: the relinquished property and the replacement property. However, delayed exchange transactions involving multiple relinquished properties and/or multiple

55. Such features include the ability to substantially leverage the investment, the limited supply of real estate, the ability to generate current income while maximizing wealth, and the tax preferences afforded real estate investments.

56. To continue the example discussed in notes 52-54, *supra*, if the taxpayer sells the property at the end of year 1, and pays the tax on his gain at the maximum 28% tax rate, he has only $17,200 left to invest, the original $10,000 but only $7,200 of the gain.

57. H.R. REP. No. 432, *supra* note 37, at 896.

https://scholarlycommons.law.cwsl.edu/cwlr/vol27/iss2/7

replacement properties are becoming increasingly common.[58]

The delayed exchange is also uniquely suited to exchanges of multiple properties.[59] A concurrent exchange of multiple properties exponentially increases the difficulties of resolving the conflicting interests of the parties to the exchange. In the delayed exchange, however, each transaction can be treated separately. As each property is closed, the proceeds of the transactions can be accumulated and then disbursed. Thus, all the transactions can be treated independently of all the others.

D. The Mechanics of a Delayed Exchange

The mechanics of the typical four-party delayed exchange (whether including multiple properties or not) are fairly straightforward in principle. The first step involves the taxpayer finding a buyer for the relinquished property (or the buyer finding the taxpayer). Typically, the taxpayer and the buyer negotiate the terms of the transfer and execute a contract of sale. The contract usually provides, however, that the sale is contingent on the taxpayer effecting and the buyer cooperating in an exchange.

The taxpayer then contracts with a person or entity not related to any parties in the exchange to accommodate the transaction. The sale contract is then assigned to the accommodator who, at closing, takes title to the relinquished property and concurrently deeds it to the buyer. The accommodator receives and holds the proceeds of the sale, pursuant to his contract with the taxpayer, to be used to purchase replacement property.

Under section 1031(a)(3), the taxpayer has forty-five days after the close of the above transaction to locate and identify replacement property. In practice, the taxpayer often starts looking before the relinquished property transaction closes and negotiates with several prospective sellers before deciding on the exact property to be acquired. At some point, the taxpayer signs a contract with a seller to purchase the replacement property. This contract also usually provides that the purchase is part of an exchange with which the seller agrees to cooperate.

The purchase contract is then assigned to the accommodator who theoretically uses the proceeds from the sale of the relinquished property to purchase the replacement property. In practice, however, those proceeds are often insufficient to close the replacement property transaction. In that case, the taxpayer arranges additional financing and/or deposits additional cash with the accommodator to make up the difference. The accommodator then closes the transaction

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58. For example, a taxpayer may exchange two or more properties into one higher value property or two or more such properties. Alternatively, the taxpayer may exchange one property into two or more properties. Using the example at discussed in note 53, *supra*, the taxpayer may exchange his one property worth $120,000 at the end of the first year into two properties worth $100,000 each by reinvesting the proceeds from the first property ($20,000) equally (or in any other proportion he wishes) in each replacement property.

59. *Starker* is actually an example of the multiple property exchange since the Starkers received twelve properties in exchange for their timberland. *See Starker III*, 602 F.2d at 1343.

with the seller and concurrently deeds title to the replacement property to the taxpayer.

II. ISSUES ADDRESSED BY THE PROPOSED REGULATIONS

Generally, the proposed regulations published by the Service on May 16, 1990,[60] address not only issues raised by the amendment to section 1031 enacted by Congress in 1984, but also several other issues that the statute did not address but which are crucial to the determination that a taxpayer has exchanged property rather than engaged in a sale/repurchase. This Section discusses the significant issues addressed by these regulations.

A. Identification Rules

One of the critical requirements in the Internal Revenue Code for a transaction to qualify as an exchange is that the taxpayer identify replacement property within forty-five days of transferring the relinquished property.[61] After the amendment was passed, questions quickly arose as to what is required to "identify" property to be received.

The proposed regulations address that issue by providing that property may be "identified" in one of three ways. First, the proposed regulations provide that any property actually received by the taxpayer before the end of the identification period is conclusively identified for purposes of section 1031.[62] Second, property may be identified "in a written document signed by the taxpayer"[63] sent[64] before the end of the forty-five days to someone involved in the exchange who is not a related party.[65] Finally, the property may be identified in a written exchange agreement signed by all parties to the exchange within the forty-five days.[66] The regulations also provide that, to be considered "identified," the property must be "unambiguously described."[67] For real property, this means

60. Prop. Treas. Reg. § 1.031(a)-3, 55 Fed. Reg. at 20,282.

61. I.R.C. § 1031(a)(3) provides that:

> [A]ny property received by the taxpayer shall be treated as property which is not like-kind property if–
>
> (A) such 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. . . .

Id.

62. Prop. Treas. Reg. § 1.1031(a)-3(c) (1), 55 Fed. Reg. at 20,283.

63. Prop. Treas. Reg. § 1.1031(a)-3(c) (2), 55 Fed. Reg. at 20,283.

64. Almost any means are allowed, including mail, hand delivery, telecopier, "or otherwise" (but not telegram or telex). *Id.*

65. Related parties, for purposes of this regulation, are discussed in Section II.C., *infra.*

66. Prop. Treas. Reg. § 1.1031(a)-3(c) (2), 55 Fed. Reg. at 20,283.

67. Prop. Treas. Reg. § 1.1031(a)-3(c) (3), 55 Fed. Reg. at 20,283.

a legal description or street address.[68]

The regulations allow a taxpayer to identify multiple and alternative properties as well.[69] However, the regulations limit the number of replacement properties that may be identified, regardless of how many properties are relinquished.[70] First, the taxpayer may identify three properties (the "3-property rule") without regard to their value. Alternatively, the taxpayer may identify "any number of properties as long as their aggregate fair market value as of the end of the identification period does not exceed 200% of the aggregate fair market value of all the relinquished properties as of the date the relinquished properties were transferred by the taxpayer" (the "200-percent rule").[71]

The penalty for not complying with these requirements is disallowance of non-recognition treatment by a presumption that the taxpayer has identified no property at all.[72] This penalty may be avoided, however, in one of two ways. First, any property received before the end of the identification period (whether or not the identification meets either of the above tests) qualifies as identified.[73] Second, more than three properties with aggregate fair market value exceeding 200% of the value of the relinquished properties will qualify as identified if the replacement property actually received has a value equal to at least 95% of the value of all properties identified (the "95-percent rule").[74]

An identification of property may also be revoked at any time before the end of the identification period.[75] Revocation is accomplished by sending a written revocation to the same person to whom the identification was sent.[76] The effect of the revocation is the same as if the property had never been identified.[77]

B. Constructive Receipt and Safe Harbors

1. The Issue of Constructive Receipt. To qualify as an exchange, the property

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68. *Id.*

69. Prop. Treas. Reg. § 1.1031(a)-3(c) (4) (i), 55 Fed. Reg. at 20,283. This is common where the taxpayer wishes to exchange into more than one property or when the taxpayer is negotiating with several prospective sellers but has not decided on which property or properties will replace the relinquished property.

70. *Id.*

71. Prop. Treas. Reg. § 1.1031(a)-3(c) (4) (i) (B), 55 Fed. Reg. at 20,283.

72. Prop. Treas. Reg. § 1.1031(a)-3(c) (4) (ii), 55 Fed. Reg. at 20,283.

73. Prop. Treas. Reg. § 1.1031(a)-3(c) (4) (ii) (A), 55 Fed. Reg. at 20,283.

74. Prop. Treas. Reg. § 1.1031(a)-3(c) (4) (ii) (B), 55 Fed. Reg. at 20,283. An example of the latter exception is as follows. The taxpayer has relinquished property worth $100,000. He identifies four properties A, B, C, and D worth $50,000, $60,000, $70,000 and $80,000, respectively. This property does not qualify under either the 3-property rule or the 200-percent rule (the aggregate fair market value of the identified properties is $260,000, more than 200-percent of the value of the relinquished property). These properties will qualify as identified, however, so long as the taxpayer receives all four of the properties. By doing so, he has received property whose value is greater than 95-percent of the aggregate fair market value of all the properties identified (in fact, it is 100%).

75. Prop. Treas. Reg. § 1.1031(a)-3(c) (6), 55 Fed. Reg. at 20,284.

76. *Id.*

77. Prop. Treas. Reg. § 1.1031(a)-3(c) (4) (iii), 55 Fed. Reg. at 20,283.

received must be like-kind to the property relinquished.[78] Cash is not like-kind to real estate. If the taxpayer receives cash for the full value of the relinquished property,[79] the transaction will not qualify as an exchange and any gain or loss on the transaction will be recognized for tax purposes.[80] An issue of constructive receipt arises where the taxpayer does not actually receive the cash generated from transferring the relinquished property but has so much control over the disposition of the cash that it will be deemed constructively received.

A delayed exchange poses particular problems with respect to the receipt of cash. In a delayed exchange, the transfer of the relinquished property actually generates cash which the accommodator holds and uses to acquire replacement property. To the extent the taxpayer actually receives that cash or controls its disposition by the accommodator, his exchange may be disallowed.[81]

While the issue of the constructive receipt of cash in delayed exchanges has never before been explicitly addressed by the Service in regulations, the issue has been litigated. In *Garcia*,[82] for example, the taxpayer never actually received the proceeds from the sale of the relinquished property. The Service argued, however, that the taxpayer constructively received cash when the accommodator transferred funds from one sale escrow (used to convey the relinquished property from the accommodator to a buyer) through an intermediate exchange escrow (used to actually exchange the properties between the accommodator and the taxpayer) to a second sale escrow (used to convey the replacement property from the seller to the accommodator).[83] The court rejected the Service's argument, holding that as long as there were "substantial limitations" on the disposition of the funds in the Garcia's exchange escrow, the funds were not constructively received by the taxpayer.[84] The court found substantial limitations in the fact that the taxpayer had no right to withdraw or apply the funds from the escrow since the funds were restricted by the contractual obligation to acquire replacement property.[85]

Related to the issue of constructive receipt is the issue of the accommodator's

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78. I.R.C. § 1031(a)(1).

79. Cash and "other property" received along with replacement property (i.e., "mixed property") is covered by I.R.C. § 1031(b). They are considered elements of "boot" which are taxable up to the amount of the gain realized on the exchange. Boot rules are themselves complex and are not the subject of this Note. For purposes of this Note, the issue of constructive receipt is involved only when the taxpayer receives cash in the full amount of the proceeds from the transfer of the relinquished property whether or not he actually receives replacement property subsequent to the actual or constructive receipt of the cash.

80. Department of the Treasury, Notice of Proposed Rulemaking, Like-Kind Exchanges--Limitations on Deferred Exchanges; and Inapplicability of Section 1031 to Exchanges of Partnership Interests, *Supplementary Information*, 55 Fed. Reg. 20,278, 20,281 (1990) [hereinafter *Supplementary Information*].

81. *Id.*

82. *Garcia*, 80 T.C. 491. While *Garcia* involved a concurrent exchange, the constructive receipt issue is similar.

83. *Id.* at 499.

84. *Id.* at 500.

85. *Id.*

agency status. An accommodator usually has no stake in the exchange other than a fee for accommodation services. In practice, however, the accommodator is usually selected by the taxpayer and has a contractual obligation solely to the taxpayer. If the accommodator receives the funds (as is usual) and is deemed an agent of the taxpayer, the latter has constructive receipt of those funds under the rules of agency.[86]

The Service has often argued that the taxpayer/accommodator relationship amounts to one of agency.[87] The courts, on the other hand, have almost always rejected the Service's arguments. To date, however, the issue has never been litigated with respect to the unique taxpayer/accommodator relationship found in a delayed (as opposed to a concurrent) exchange.

Nevertheless, based partly on the case law on concurrent exchanges, taxpayers and accommodators have adopted a number of devices for structuring delayed exchanges to avoid having cash from the sale of the relinquished property being deemed constructively received by the taxpayer. One of the most common techniques is for the accommodator to assume full control over the funds, secured only by the accommodator's contractual obligation to deliver like-kind property. In effect, the cash becomes the property of the accommodator, to be used as he sees fit, subject only to the contractual obligation.[88]

Not surprisingly, then, taxpayers and accommodators have devised other arrangements to protect the taxpayer from accommodator default. These arrangements include standby letters of credit and deposit of the funds into escrow or trust accounts with the taxpayer as beneficiary. Before the proposed regulations were published, the extent to which a taxpayer could employ security arrangements before the taxpayer would be deemed to have constructively received the cash was unclear.

Finally, investing the funds generated from the transfer of the relinquished property in an interest bearing instrument is not uncommon. This tactic, however, raises the issue of whether the taxpayer is deemed to have constructively received the principal if he receives the interest on the invested funds.[89]

2. Avoiding the Issue—"Safe Harbors." For purposes of section 1031(a)(3), the proposed regulations provide that the taxpayer receives the cash when he actually receives it or "receives the economic benefit" of it.[90] The regulations also

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86. Prop. Treas. Reg. § 1.1031(a)-3(f) (2) provides that "actual or constructive receipt of money . . . by an agent of the taxpayer . . . is actual or constructive receipt by the taxpayer." 55 Fed. Reg. at 20,286.

87. *See, e.g., Mercantile*, 32 B.T.A. 82; *Coupe*, 52 T.C. 394; *Garcia*, 80 T.C. 491.

88. The recent bankruptcy of one such accommodator, however, illustrates the danger to the taxpayer in this arrangement. *See* Biberman, *How Do You Pick an Accommodator For Tax Deferred Exchanges?*, San Diego Daily Transcript, June 25, 1990, at 1B, col. 1.

89. A familiar tax metaphor is the Fruit of the Tree metaphor which asserts that receiving the benefits of the fruits implies ownership of the tree. If the taxpayer benefits from the interest on the proceeds of the sale, then he can be assumed to own them and is therefore in constructive receipt of them.

90. Prop. Treas. Reg. § 1.1031(a)-3(f) (2), 55 Fed. Reg. at 20,286.

provide that the taxpayer constructively receives cash when the money "is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon [the cash] at any time or so that the taxpayer can draw upon [the cash] if notice of intention to withdraw is given."[91] Even if the funds are substantially limited or restricted, the taxpayer has constructive receipt of the funds when the limits or restrictions "lapse, expire or are waived."[92]

In order to clarify the constructive receipt issues, the proposed regulations not only define constructive receipt[93] but also provide four "safe harbors" to bypass the issue.[94] The purpose of the safe harbors is to provide taxpayers with several techniques for structuring delayed exchanges which generally result in a presumption that the taxpayer has not constructively received the funds in the exchange.[95] Use of these safe harbors is limited, however, by the requirement that the taxpayer not have the ability or "unrestricted right to receive money... before the taxpayer receives like-kind replacement property."[96] Such an ability or right will defeat the exchange entirely.[97]

Safe Harbor #1–Security or Guarantee Arrangements. The taxpayer is allowed to secure the accommodator's obligation by a mortgage, deed of trust, or other security interest (other than cash); a standby letter of credit "which satisfies all of the requirements of [I.R.C.] section 15A.453-1(b)(3)(iii)[98] and which does not allow the taxpayer to draw on such standby letter of credit except upon default of [the accommodator's] obligation to transfer like-kind. . ." property; or a third-party guarantee of the accommodator's obligation.[99]

Safe Harbor #2–Qualified Escrow Accounts and Qualified Trusts. This provision allows the cash proceeds from the transfer of the relinquished property to be held in an escrow or trust account. An escrow account for purposes of this

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91. *Id.*
92. *Id.*
93. *Id.*
94. Prop. Treas. Reg. § 1.1031(a)-3(g), 55 Fed. Reg. at 20,286.
95. Prop. Treas. Reg. § 1.1031(a)-3(g) (1), 55 Fed. Reg. at 20,286.
96. *Id.*
97. *Id.*
98. The text of I.R.C. § 15A.453-1(b)(3)(iii) is as follows:

> The term "standby letter of credit" means a non-negotiable, non-transferable (except together with the evidence of indebtedness which it secures) letter of credit, issued by a bank or other financial institution, which serves as a guarantee of the evidence of indebtedness which is secured by the letter of credit.... The mere right of the secured party . . . to transfer the proceeds of a letter of credit shall be disregarded in determining whether the instrument qualifies as a standby letter of credit. A letter of credit is not a standby letter of credit if it may be drawn upon in the absence of default in payment of the underlying evidence of indebtedness.

Id.

99. Prop. Treas. Reg. § 1.1031(a)-3(g)(2), 55 Fed. Reg. at 20,286.

safe harbor is one where the escrow holder is not the taxpayer or a related party. Also, the right of the taxpayer "to receive, pledge, borrow, or otherwise obtain the benefits of the cash" so held is limited to the circumstances discussed in the section below on *Additional Restrictions*.[100] The trust account must meet the same requirements.[101]

Safe Harbor #3–Qualified Intermediaries. This safe harbor allows the taxpayer to use an accommodator, whether or not an agent, to take title to the relinquished property and to hold the proceeds from the transfer of that property so long as the accommodator meets the following requirements:[102]

- the taxpayer's rights to receive cash from the accommodator must be limited to the circumstances discussed in the section below on *Additional Restrictions*;
- the accommodator must be "qualified."[103]

A "qualified" accommodator is a person or entity who is not the taxpayer or a related party who, under contract with the taxpayer and for a fee, (1) takes title to the taxpayer's property, (2) acquires the replacement property, then (3) transfers the replacement property to the taxpayer.[104]

Safe Harbor #4–Interest and Growth Factors. This safe harbor provides that an exchange will not be defeated simply because the taxpayer receives interest on the invested proceeds from the transfer of the relinquished property while they are being held to acquire the replacement property.[105]

Additional Restrictions. For purposes of the safe harbors, the right of the taxpayer to receive cash must be limited to the following circumstances.

- The taxpayer can have the right to receive cash at the end of the forty-five day identification period if he has not identified replacement property within that period.[106]
- The taxpayer can have the right to receive cash after all replacement property has been acquired.[107]
- The taxpayer can have the right to receive cash at the end of the exchange

100. Prop. Treas. Reg. § 1.1031(a)-3(g)(3)(ii), 55 Fed. Reg. at 20,286.
101. Prop. Treas. Reg. § 1.1031(a)-3(g)(3)(iii), 55 Fed. Reg. at 20,286.
102. Prop. Treas. Reg. § 1.1031(a)-3(g)(4)(i), 55 Fed. Reg. at 20,286.
103. *Id.*
104. Prop. Treas. Reg. § 1.1031(a)-3(g)(4)(ii), 55 Fed. Reg. at 20,286.
105. Prop. Treas. Reg. § 1.1031(a)-3(g)(5), 55 Fed. Reg. at 20,287.
106. Prop. Treas. Reg. § 1.1031(a)-3(g)(6)(i), 55 Fed. Reg. at 20,287.
107. Prop. Treas. Reg. § 1.1031(a)-3(g)(6)(ii), 55 Fed. Reg. at 20,287.

period.[108]

- The taxpayer can have the right to receive cash after the end of the identification period (but before the end of the exchange period) upon the "occurrence of a material and substantial contingency."[109]

Such contingencies must relate to the exchange, be in writing, and be "beyond the control of the taxpayer or a related party."[110] Examples of contingencies beyond the control of the taxpayer include destruction of the property or failure to obtain zoning approval.[111]

The safe harbors do not appear to be exclusive. The proposed regulations provide that the use of the safe harbors will result in a determination of non-receipt, and the taxpayer may use any combination of safe harbors.[112] Thus, apparently the taxpayer may, for example, use a qualified intermediary holding his funds in a qualified trust account in a bank which pays interest on the funds, which are secured by a standby letter of credit.

C. Related Parties

As noted above, exchanges may be disallowed if certain features of the exchange involve related parties. The proposed regulations provide three definitions of related parties.[113]

- A related party is a person related to the taxpayer as described in section 267(b) or section 707(b) of the Internal Revenue Code "(substituting '10 percent' for '50 percent' each place it appears.)."[114]

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108. Prop. Treas. Reg. § 1.1031(a)-3(g)(6)(iv), 55 Fed. Reg. at 20,287. The exchange period ends one hundred eighty days after the transfer of the first relinquished property or the due date of the taxpayer's tax return (with regard to extensions), whichever comes first. I.R.C. § 1031(a)(3)(B).

109. Prop. Treas. Reg. § 1.1031(a)-3(g)(6)(iii), 55 Fed. Reg. at 20,287.

110. Prop. Treas. Reg. § 1.1031(a)-3(g)(6)(iii), 55 Fed. Reg. at 20,287.

111. Prop. Treas. Reg. § 1.1031(a)-3(g)(7), example 2(i), 55 Fed. Reg. at 20,287.

112. Prop. Treas. Reg. § 1.1031(a)-3(g), 55 Fed. Reg. at 20,286.

113. Prop. Treas. Reg. § 1.1031(a)-3(k)(1), 55 Fed. Reg. at 20,289.

114. Prop. Treas. Reg. § 1.1031(a)-3(k)(1)(i), 55 Fed. Reg. at 20,289. I.R.C. § 267(b) defines the following relationships: members of a family; an individual and a corporation more than 50% owned, directly or indirectly, by the individual; two corporations of the same controlled group; grantor and fiduciary of a trust; fiduciary of a trust and a fiduciary of another trust if the grantors are the same; a fiduciary of a trust and the beneficiary of another trust if the grantors are the same; a fiduciary of a trust and a corporation more than 50% owned by or for the trust or by or for the grantor of the trust; a person and a charitable organization controlled by the person; a corporation and a partnership where both are more than 50% owned by the same persons; two S corporations if the same persons own 50% of the stock in each; an S and a C corporation where the same persons own more than 50% of each. I.R.C. § 707(b) concerns controlled partnerships. That section defines two relationships. They are a partnership 50% owned by the taxpayer and two partnerships in which the same person owns more than 50% of the partnership interest. *Id.*

Thus, for purposes of section 1031 delayed exchanges, the proposed regulations incorporate the related party definitions found in subsections 267(b) and 707(b) of the Internal Revenue Code of 1986. But, in doing so, the propsosed regulations expand the subsection 267(b) and 707(b) definitions by requiring the substitution of "'10 percent' for '50 percent' each place it appears" in those two

- A party is related if that party otherwise is the taxpayer's agent. Such parties include employees, attorneys, or brokers.[115]
- A party is related to the taxpayer if that party is related to the agent.[116] Relationship to the agent is determined as if the agent were the taxpayer.[117]

Excluded from these definitions are parties who perform services solely with respect to the exchange[118] and financial institutions providing routine services for the taxpayer.[119]

D. Other Provisions

This sub-section discusses several other significant provisions covered in the proposed regulations.

1. Incidental Property. In commercial transactions, personal property is commonly transferred along with real property. An example is the transfer of furniture or laundry machines incident to the transfer of an apartment building.[120] The proposed regulations provide that an exchange will not be defeated in these situations where such personal property is "typically transferred" with the real estate and the "aggregate fair market value of all such property does not exceed" 15% of the total value of the property.[121]

2. "Substantially the Same" Property. For purposes of an exchange, the replacement property received must be "substantially the same" as the property identified.[122] Otherwise, the replacement property will not be deemed to have been identified and the exchange will be defeated. The regulations do not define

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sections. The effect of this substitution, is that, for purposes of section 1031 delayed exchanges, related parties are more broadly defined to include (1) an individual and a corporation more than 10% owned by the individual; (2) a fiduciary of a trust and a corporation more than 10% owned by or for the trust or by or for the grantor of the trust; (3) a corporation and a partnership where both are more than 10% owned by the same person; (4) two S corporations if the same persons own 10% of the stock in each; (5) an S and a C corporation where the same persons own more than 10% of each; (6) an individual and a taxpayer where the taxpayer owns 10% of the partnership; (7) two partnerships where the same person owns more than 10% of the partnership interest.

115. Prop. Treas. Reg. § 1.1031(a)-3(k)(1)(iii), 55 Fed. Reg. at 20,289.

116. Prop. Treas. Reg. § 1.1031(a)-3(k)(1)(iii), 55 Fed. Reg. at 20,289. For example, the wife of the taxpayer's attorney is also related to the taxpayer for purposes of this section.

117. That is if the party is related to the agent as described in I.R.C. § 267(b) or § 707(b), "Substituting '10 percent' for '50 percent' each place it appears." Prop. Treas. Reg. § 1.1031(a)-3(k)(1)(iii), 55 Fed. Reg. at 20,289.

118. Prop. Treas. Reg. § 1.1031(a)-3(k)(2)(i), 55 Fed. Reg. at 20,289. Presumably, this means that an accommodator who is not the agent of the taxpayer for other services is not the agent of the taxpayer (and thus not a related party) for purposes of providing services under these regulations.

119. Prop. Treas. Reg. § 1.1031(a)-3(k)(2)(ii), 55 Fed. Reg. at 20,289.

120. Prop. Treas. Reg. § 1.1031(a)-3(c)(5), 55 Fed. Reg. at 20,283.

121. *Id.*

122. Prop. Treas. Reg. § 1.1031(a)-3(d)(1)(ii), 55 Fed. Reg. at 20,285.

the term "substantially the same."[123] However, in an example illustrating this provision, the regulations suggest that received property having a value of at least 75% of the identified property qualifies as having been identified.[124]

3. The "Weekend Rule." Section 7503 of the Internal Revenue Code[125] provides that when the last day for performing some act under the Internal Revenue Code falls on a Saturday, Sunday, or legal holiday, such act is legally performed if the act is performed on the next business day following the weekend or holiday.[126] The regulations provide, however, that this section will not apply to the end of the identification or replacement period.[127] Thus, for example, if the end of the forty-five day identification period falls on a Saturday, the taxpayer will not have identified the property if he sends his identification in writing to a qualified party on the following Monday. He must send the identification on or before the Saturday.

4. "To be Produced" Property. Replacement property may sometimes be land upon which the seller, pursuant to the contract with the taxpayer, is to construct improvements. In general, the proposed regulations allow such property to qualify as replacement property.[128]

Such property is identified, for purposes of the regulations, if the property is identified by a legal description and with as much detail as to the improvements to be constructed as is practical.[129] For purposes of valuing the property under the "200-percent rule"[130] or "incidental property rule,"[131] the regulations provide that an estimate of the fair market value of the property as of the date the property will be received is sufficient.[132]

Minor variations in the construction of the property are not taken into account when determining whether the property received is substantially the same as that identified.[133] If the improvements are not completed as of the date the property is transferred to the taxpayer, the property will still be considered

123. *Id.*

124. Prop. Treas. Reg. § 1.1031(a)-3(d), Example 2 (ii), 55 Fed. Reg. at 20,285.

125. I.R.C. § 7503 reads:

> When the last day prescribed under authority of the internal revenue laws for performing any act falls on Saturday, Sunday, or a legal holiday, the performance of such act shall be considered timely if it is performed on the next succeeding day which is not a Saturday, Sunday, or a legal holiday. . . .

Id.

126. *Id.*

127. Prop. Treas. Reg. § 1.1031(a)-3(b)(2)(iii), 55 Fed. Reg. at 20,283.

128. Prop. Treas. Reg. § 1.1031(a)-3(e)(1), 55 Fed. Reg. at 20,285.

129. Prop. Treas. Reg. § 1.1031(a)-3(e)(2)(i), 55 Fed. Reg. at 20,285.

130. *See* Section II.A., *supra.*

131. *See* Section II.D.1., *supra.*

132. Prop. Treas. Reg. § 1.1031(a)-3(e)(2)(ii), 55 Fed. Reg. at 20,285.

133. Prop. Treas. Reg. § 1.1031(a)-3(e)(3)(i), 55 Fed. Reg. at 20,285.

replacement property if the actually received property is (1) real property as received and (2) would have been substantially the same property as identified had the improvements been completed.[134]

III. ANALYSIS

From the taxpayer's point of view, the regulations respond favorably to a number of actual and potential issues raised by the inherent structure of the delayed exchange transaction. First, the regulations are more comprehensive than the Internal Revenue Code requires. Not only do the regulations address issues raised by the statute, but they go beyond to address issues implied by the nature of the transaction itself. Also, to a large extent, the regulations appear to accord with actual industry practices. For example, the safe harbors are particularly designed to address issues that taxpayers actually face in structuring delayed exchanges. The regulations do not appear, then, to have been designed in a vacuum. There are, however, several serious and some minor problems with the regulations which are discussed in this section.

The following discussion addresses the regulations in terms of both the statute and its legislative history and the realities of the real estate marketplace. Both the positive and negative features of the regulations are noted.

A. Identification Rules

One of the most serious deficiencies in the statute is what constitutes "identification." The legislative history provides only minimal guidance. The Conference Report[135] states that "the designation requirement *may* be met by designating the property to be received in the contract between the parties."[136] This permissive language and the lack of any other standards as to what constitutes "identification" has, in practice, resulted in the use of all kinds of questionable methods.[137]

Apparently, the proposed regulations are in accord with the Conference Report by allowing identification in a written agreement for the exchange "signed by all parties thereto."[138] However, this method is more restrictive than what the Conference Report implies. First, the Conference Report language implies that any contract involving the taxpayer is appropriate for identifying the replacement property. Such contracts could include one between the taxpayer

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134. Prop. Treas. Reg. § 1.1031(a)-3(e)(3)(iii), 55 Fed. Reg. at 20,285. Note, however, that the value of the property for purposes of section 1031 is the value *as of the date of the transfer.* The value of the services to finish the construction is not treated as "like-kind" property and may be taxable "boot." Prop. Treas. Reg. § 1.1031(a)-3(e)(4), 55 Fed. Reg. at 20,285.

135. H.R. REP. No. 861, 98th Cong., 2d Sess. 865, *reprinted in* 1984 U.S. CODE CONG. & ADMIN. NEWS 1445, 1553.

136. *Id.* (emphasis added).

137. One example is the identification of all properties in a real estate multiple listing service printout as possible replacement properties.

138. Prop. Treas. Reg. § 1.1031(a)-3(c)(2), 55 Fed. Reg. at 20,283.

and the seller of the replacement property and/or one between the taxpayer and the accommodator. The proposed regulations, however, specify that only a contract signed by *all* the parties wherein replacement property is identified satisfies the identification requirement.[139]

At a minimum, a delayed exchange will involve three parties[140] and more often at least four.[141] Since the transaction involved is a *delayed* exchange, the notion that *all* parties will be available to sign the exchange agreement is highly unlikely. In fact, the usual custom is that only the taxpayer and the accommodator sign the exchange agreement itself. Thus, whether this provision of the proposed regulations conforms to either congressional intent or industry practice is questionable.

On the other hand, the proposed regulations provide a method for identifying the replacement property that is more generous than the statute literally requires. Under the regulations, the taxpayer need only notify a non-related party to the transaction, in writing, of the replacement property, along with an unambiguous description of the replacement property.[142] This appears to be a flexible and practical approach to the identification issue. This approach is not prohibited by the statute nor the legislative history and conforms to industry expectations. Also, the approach is sufficiently definite so as to avoid most abuses,[143] yet flexible enough to afford the taxpayer several methods for transmitting the written document and several parties to receive it.[144]

The regulations are also flexible in allowing multiple and/or alternative designations of replacement property.[145] This gives the taxpayer time and flexibility to identify more properties than he may ultimately receive in the exchange. For example, the taxpayer may negotiate with two or three sellers of property when he will ultimately acquire his replacement property from only one seller.

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139. *Id.*

140. The typical transaction involves the buyer of the relinquished property, the taxpayer, and the seller of the replacement property.

141. The buyer of the relinquished property, the taxpayer, the seller, and the accommodator.

142. Prop. Treas. Reg. § 1.1031(a)-3(c)(3), 55 Fed. Reg. at 20,283.

143. For example, requiring "unambiguous identification" would prohibit such identifications as "one or more parcels of property in San Diego County."

144. The identification provision, however, creates a potentially large loophole in the identification rules to the Service's disadvantage. The regulations allow the taxpayer to send his identification notice to the seller of the replacement property. Prop. Treas. Reg. § 1.1031(a)-3(c)(2), 55 Fed. Reg. at 20,283. A creative taxpayer could send identification notices to literally hundreds of potential sellers even though he intends to complete the exchange with only one or very few of them. As long as he meets the other requirements of the identification rules, his identification notices to those sellers with whom he completes the exchange will meet the notice requirements. However, by sending identification notices to many more sellers than those with whom he completes the exchange, he has violated the 3-property, 200-percent, and 95-percent rules. The problem is that there is no way to detect this violation unless one or more of the other sellers comes forward. *See* Letter from Kathy Holborn-Robinson, President of Park Camino Escrow Inc., to Internal Revenue Service (July 23, 1990) (commenting on the proposed regulations) (available at California Western School of Law, Law Review offices) [hereinafter Park Camino Letter].

145. *See* Section II.B., *supra*.

There are some serious practical problems with those rules, however. First, there are potentially dangerous pitfalls if the exchange involves more than one relinquished property and each relinquished property is transferred on different dates. The regulations provide that both the identification and the replacement period begin on the date the first property is transferred.[146] Thus, replacement property identified within forty-five days of the second relinquished property but outside the forty-five day limit with respect to the first will disqualify the *entire* exchange.[147]

There is also a problem with the "200-percent rule." Since that rule is based on the gross value of the property, the rule has the effect of severely limiting the ability of the taxpayer to leverage his investment in the relinquished property into replacement properties. Consider, for example, a taxpayer who purchased a property five years ago for $1,000,000 which was 80% financed by a mortgage. Assume that today, the property is worth $1,500,000 and the mortgage is worth only $780,000. The taxpayer now has equity of $720,000. The taxpayer wishes to exchange that property into five properties. Under the "200-percent rule," he is limited to investing in properties worth no more than $3,000,000. However, under conventional investment practice, he would wish to invest his equity at the rate of only 20% of the value of each of the five properties for a total value of $3,600,000. Thus, under the "200-percent rule," the taxpayer is limited in his ability to maximize his wealth. As the ratio of debt to equity in relinquished property declines, the limiting effects of the "200-percent rule" become even greater.[148]

Of course, the hypothetical taxpayer above could use the "95-percent rule." However, that rule poses potential problems as well.[149] Assuming the same facts as above, if any one or more of the properties is not conveyed to the taxpayer before the end of the exchange period, the taxpayer is considered not to have identified *any* property and the whole exchange will fail. This situation is not unusual since real estate contracts almost always contain contingencies which could fail and delays in closing are almost inevitable.

Thus, while the identification rules seem to be reasonable and generous, they are potentially very limiting and can operate as a trap for the unwary investor.

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146. Prop. Treas. Reg. § 1.1031(a)-3(b)(2)(iii), 55 Fed. Reg. at 20,283.

147. *See* Park Camino Letter, *supra* note 144, at 3. For example, assuming the first relinquished property was transferred on June 1, 1990 and the second on July 1, 1990. Replacement property is located and identified on July 20, 1990. Not only would the replacement property not qualify as identified for the first relinquished property (because the replacement property was identified beyond the forty-five day identification period ending on July 16, 1990), but neither would the replacement property qualify as identified for exchange with the second relinquished property since the identification period for the whole exchange begins when the first property is relinquished.

148. *Accord* H. Levine, Some Thoughts on the Proposed Delayed Exchange Regulations 2 (materials for presentation at the Third Annual Conference on Section 1031 Real Estate Exchanges, National Real Estate Development Center (Los Angeles, Cal. June 25-26, 1990)) (available at California Western School of Law, Law Review offices).

149. *See* Park Camino Letter, *supra* note 144, at 8.

B. Constructive Receipt and Safe Harbors

The legislative history is wholly silent on the issue of constructive receipt. Thus, the safe harbors respond to industry concerns. Generally, the safe harbors appear to be a well balanced attempt to address the underlying concern that a delayed exchange is, in reality, a sale/repurchase. Also, the safe harbors accommodate the needs of taxpayers for flexible techniques for structuring exchanges.

In fact, the safe harbors go beyond the constructive receipt issue to allow the taxpayer to structure security arrangements to ensure the performance of accommodators. Arguably, the ability to secure accommodator performance is more important than constructive receipt.[150] Therein lies one of the problems with the proposed regulations.

1. The Security or Guarantee Arrangements. In the usual exchange, the taxpayer conveys the relinquished property to an accommodator who then reconveys the property to the buyer for the agreed consideration. The accommodator holds the proceeds to be used to acquire the replacement property. Typically, the only rights the taxpayer has against the accommodator are contractual, to deliver like-kind property before the end of the exchange period or cash (if the accommodator is unable or unwilling to deliver the replacement property). In effect, the taxpayer conveys away a substantial asset with almost no security.

One security arrangement allowed by the regulations is a mortgage, deed of trust, or other security interest in property other than cash.[151] The problem here is determining which property serves as the security. If, by "property" the regulations intend to mean the relinquished property, significant problems can be anticipated.[152] First, the buyer is not likely to agree to encumber the property he receives.[153] Second, the property is probably already encumbered by one or more mortgages or trust deeds with priority and the beneficiaries of those mortgages or trust deeds are not likely to agree to further encumbrances which might jeopardize their secured positions.[154]

The property secured might also be the property held by the accommodator. Typically, though, an accommodation is a service business, and there is no property to be secured. Thus, this option is probably of little value to the taxpayer. Similarly, third party guarantees are not likely to be widely used. Only

150. *See* T. Cuff, Understanding the New Regulations on Deferred Exchanges 35 (materials for presentation at the Third Annual Conference on Section 1031 Real Estate Exchanges, National Real Estate Development Center (Los Angeles, Cal. June 25-26, 1990)) (available at California Western School of Law, Law Review offices) [hereinafter Cuff].

151. Prop. Treas. Reg. § 1.1031(a)-3(g)(2)(i), 55 Fed. Reg. at 20,286.

152. Cuff, *supra* note 150, at 36.

153. *Id.* at 37.

154. *Id.*

in rare instances will there be a financially strong third party willing to guarantee the performance of an accommodator.[155]

A standby letter of credit may be, however, a more practical form of security against the accommodator's default, if properly structured. The standby letter of credit would be issued by a bank or other financial institution and secured by the cash proceeds from the relinquished property deposited with the bank. In the event of default, the bank would pay on the letter of credit and immediately foreclose on the deposit account.

A potential problem arises here, however, in the definition of default.[156] The regulations provide that the standby letter of credit allow the taxpayer to draw on the letter only in the event of the accommodator's default.[157] But, who determines when the default occurs and, thus, when the issuer must pay on the letter? Typically, the standby letter of credit will provide that the taxpayer can draw upon the letter when the *taxpayer* notifies the issuer that the accommodator has defaulted. Consequently, the issue arises whether this notice complies with the regulations, or whether the right to declare default means that the taxpayer has an unrestricted right to the funds, thus placing him in constructive receipt of them.

2. *Qualified Escrow Accounts and Qualified Trusts.* The qualified escrow is potentially the most useful of the safe harbors. Unlike the security arrangements under Safe Harbor #1, the cash held in a qualified escrow account may be used to secure the performance of the accommodator. A technical problem occurs with the qualified trust, however. A trustee is a related party to the taxpayer under section 267(b)(6) of the Internal Revenue Code.[158] Thus, if the taxpayer is the beneficiary of the trust (as he should be), the trust cannot be qualified under the proposed regulations.[159]

3. *The Other Safe Harbors.* The legislative history is silent as to the use of intermediaries and the payment of interest on the invested proceeds from the relinquished property. The regulations appear, however, to approve of common techniques used to effect exchanges. While the use of intermediaries as accommodators of concurrent exchanges had been specifically approved in a number of litigated cases, their use in the delayed exchange context prior to the regulations was not settled. The issues of agency and constructive receipt have always been concerns. The regulations, then, are quite liberal in approving this technique. The regulations go so far as to state that even if the accommodator is actually held to be an agent of the taxpayer, the Service will not assert

155. *Id.* at 39.
156. *Id.* at 40.
157. Prop. Treas. Reg. § 1.1031(a)-3(g)(2)(ii), 55 Fed. Reg. at 20,286.
158. *See* Section III.C., *infra*, for an analysis of the related party rules.
159. Prop. Treas. Reg. § 1.1031(a)-3(e)(3)(iii)(A), 55 Fed. Reg. at 20,285.

constructive receipt to the taxpayer of the funds held by the accommodator.[160]

The requirement that the accommodator not be a related party can be justified on the basis that a related party is little more than an extension of the taxpayer and that the funds held by such an intermediary are not, in fact, subject to substantial restrictions. By broadly defining "related party," however, many people who have traditionally acted as accommodators (such as a taxpayer's attorney or real estate broker) will no longer qualify.[161]

The interest and growth factor safe harbor appears to respond to a common abuse in the accommodator industry. Before the regulations were published, some accommodators asserted the constructive receipt issue with respect to interest to justify keeping that interest as income to themselves. On large transactions, the interest income can be considerable. The regulations, thus, eliminate that justification to abuse the unwary taxpayer.

4. Restrictions on the Safe Harbors. The restrictions on the taxpayer's rights to receive cash are certainly within the spirit, if not the letter, of the legislative history and case law. The legislative history makes clear that in the continuum of transactions from pure exchange to pure sale/repurchase, the bright line is often drawn at the taxpayer's right to receive the cash proceeds from the transfer of the relinquished property. In drawing the bright line at the taxpayer's right to receive cash, however, the regulations mask two problems, one substantive and the other technical.

The substantive problem concerns the taxpayer's ability simply to declare the exchange ineffective, accept the tax liability, and receive his proceeds.[162] The restrictions in the regulations on the taxpayer's ability to receive cash prohibit this result until at least the end of the identification period. One questions why this situation was not added to the list of events upon which the taxpayer could receive cash.

The technical problem is the inconsistency within the regulations. Example 2(i) of section 1.1031(a)-3(j)(3) of the proposed regulations illustrates the accommodator transferring $10,000 to the taxpayer when he transfers the relinquished property to the accommodator (presumably pursuant to an agreement). Transferring cash to the taxpayer when the taxpayer transfers the relinquished property to the accommodator is not, however, one of the limiting circumstances under which a taxpayer may receive cash that are specified in section 1.1031(a)-3(g)(6) of the regulations. Thus, the payment of cash in the regulation's example appears to violate the section 1.1031(a)-3(g)(6) restrictions on the taxpayer's rights to receive cash.[163]

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160. Prop. Treas. Reg. § 1.1031(a)-3(k)(2)(i), 55 Fed. Reg. at 20,289.

161. *See* Section III.C., *infra*.

162. Cuff, *supra* note 150, at 63.

163. Park Camino Letter, *supra* note 144, at 6.

C. Related Parties

There is a very strong bias in the regulations against delayed exchanges involving related parties.[164] The only legislative justification for this bias is section 1031(f) which restricts exchanges between related persons.[165] The regulations go far beyond section 1031(f), however. The regulations include not only related persons defined in section 267(b) of the Internal Revenue Code, but also those defined in section 707(b) of the Internal Revenue Code (concerning controlled partnerships) and other parties (such as the taxpayer's agents) not included in either of the other two Internal Revenue Code sections. Moreover, the regulations go beyond the requirements of section 707(b) and section 267(b) to define controlled corporations and partnerships to be those in which the taxpayer owns as little as 10% of the stock or partnership interest versus the 50% ownership provided in section 267(b) and section 707(b). Finally, the regulations prohibit the taxpayer from dealing with a party related (as defined by the regulations) to the taxpayer's agent.[166]

Presumably, these restrictions are designed to preclude the taxpayer from self-dealing[167] and from actually controlling the funds derived from the transfer of the relinquished property prior to acquiring the replacement property. They are restrictive to the point of forcing the taxpayer into the preferred boxes (the safe harbors) for no other reason than to avoid the hassles of convincing the Service that a particular party to the transaction is not related.

Two questions arise, however, about the section 267(b) and section 707(b) requirements. The first is whether there is sufficient reason to establish more restrictive requirements than already exist in a similar statutory provision concerning the same subject matter. The second is whether, as a practical matter in considering industry custom, the limitations are consonant with the problem they are intended to address.

In section 1031(f), Congress has already established special rules for exchanges between related persons.[168] Those rules provide that an exchange of properties between related persons will not qualify for nonrecognition treatment if either disposes of the property received within two years.[169] Presumably, those rules apply to all exchanges, including delayed exchanges. The legislative history behind section 1031(f), however, indicates a rather specific reason for section

164. *Id.* at 12.

165. Section 1031(f) defines a related person as "any person bearing a relationship to the taxpayer described in section 267(b)." I.R.C. § 1031(f).

166. Prop. Treas. Reg. § 1.1031(a)-3(k)(1), 55 Fed. Reg. at 20,289.

167. Self-dealing would include sending an identification notice to a wholly owned corporation, one's wife or children, or in setting up one's own accommodating corporation.

168. I.R.C. § 1031(f).

169. I.R.C. § 1031(f)(1).

1031(f). In contrast, the problem addressed by section 1031(f) is basis shifting.[170] The problem addressed by the proposed regulations is not basis shifting, but rather constructive receipt and control over the proceeds of a relinquished property transaction. Thus, arguably the applicability of the two provisions are not at all similar.

Neither are the two provisions exclusive. A delayed exchange between related persons satisfying the tests of section 1031(f) would still require the parties to conform to the requirements of section 1031(f) (e.g., hold the replacement property for two years). On the other hand, if the transaction were structured as a delayed exchange, the fact that the two exchangers are related under the proposed regulations would limit what each could do (e.g., neither could identify the replacement property to each other) but would not, by itself, invalidate the exchange.

Whether the related party rules in the proposed regulations are symmetrical with the perceived harm is more problematic. One can conceive of, for example, a particular set of circumstances under which a taxpayer will not be able to identify replacement property because everyone he notifies is related to him.[171] Also, the reasons for redefining related corporations and partnerships are suspect. The proposed regulations provide no rationale for these provisions. Certainly, a taxpayer who owns 50% or more of a corporation controls that corporation and thus has control over the disposition of its assets (including the cash proceeds of a relinquished property transaction). This situation leads logically to a constructive receipt conclusion. But there is no reason to automatically conclude that a taxpayer who owns 11% of a corporation has any more control over the corporation than one who owns 49%. Conversely, there is no reason to automatically conclude that a taxpayer who owns 10% of a corporation has any less control over that corporation than one who owns 50%.[172]

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170. *See* H.R. REP. NO. 247, 101st Cong., 1st Sess. 1340 (1989), *reprinted in* 1989 U.S. CODE CONG. & ADMIN. NEWS 1906, 2810. Basis shifting is a technique for obtaining the cash benefit of disposing of low-basis property while avoiding the tax consequences of the disposal. In a basis-shift, property having a low cost basis relative to its market value is exchanged, usually with a related party such as a corporation controlled by the taxpayer, for property with a high basis relative to market value. The taxpayer then sells the high-basis property, reaping the proceeds. But, since the difference between the market value of the property and its high basis is relatively small, the taxable gain is also small. The basis in the relinquished property has been shifted to the related party.

171. Such a situation would occur where a taxpayer exchanges property with a related person within the meaning of section 1031(f) using his attorney to accommodate the transaction. All are related parties within the meaning of Prop. Treas. Reg. § 1.1031(a)-3(k), 55 Fed. Reg. at 20,289. The accommodator is not a "qualified intermediary" within the meaning of Prop. Treas. Reg. § 1.1031(a)-3(g)(4), 55 Fed. Reg. at 20,286. But, as long as the contract with the attorney totally restricts the right of the taxpayer to receive cash, the Service would have little basis to defeat the exchange on the theory that the taxpayer has constructive receipt of the proceeds from the transfer of the relinquished property. *Accord* Cuff, *supra* note 150, at 12.

172. Consider, for example, a corporation with two shareholders: a controlling shareholder and the taxpayer. Whether the controlling shareholder owns 51% or 89% of the stock, the taxpayer has no control whatsoever. The shareholder who owns more than 50% of the stock of the corporation has virtually unlimited power to elect the managing Board of Directors of the corporation. Yet under the related party provisions of the proposed regulations, the corporation is deemed controlled by the

Basically, whether the Service needs to make the related party rules more restrictive for delayed exchanges than for all exchanges is questionable when Congress has specifically enacted related party rules.

D. Other Provisions

1. Incidental Property. "Incidental property" is inevitably transferred along with the real property in a real property exchange. The rules proposed by the Service appear to be reasonable. While there is no magic in the 15% test, it at least puts taxpayers on notice that while the issue will probably rarely be raised, transactions that involve substantial personal property will raise the issue. The test also gives taxpayers a clear standard for anticipating when that issue will be raised.

2. "Substantially the Same Property." There is no mention in the Internal Revenue Code or the legislative history that the taxpayer can receive something other than *exactly* the property he identifies. These provisions of the proposed regulations appear to be particularly generous. They do, then, respond to the realities of the marketplace. The "what" that is transferred is often not *exactly* the same as "what" was identified.

While the service does not define "substantially the same," an example indicates that property received which is worth 75% of the value of the property identified (but otherwise the same property) qualifies as "substantially the same." In this example, the Service seems to provide a reasonable illustration of the underlying concept[173]—that the property transferred in the exchange need not be exactly the same as that identified—a useful and flexible notion.[174]

3. The "Weekend Rule." While rarely a major issue in practice, the question is why the Service chose to restrict a statutory rule, on its face applicable to virtually every other provision of the Internal Revenue Code requiring the performance of an act by some date. The Service generally takes the position that section 7503 of the Internal Revenue Code is limited to acts required to be performed "in connection with the determination, collection, or refund of taxes."[175] The regulations are consistent with this position. Nevertheless, there

taxpayer whether he owns 11% or 49%. Prop. Treas. Reg. § 1.1031(a)-3(k), 55 Fed. Reg. at 20,289. On the other hand, consider a corporation with thousands of shareholders, each owning a small number of shares except the taxpayer, who holds just under 10% of the shares. While the taxpayer does not have unlimited power to elect a Board of Directors, he is definitely in a more "controlling" position than any other shareholder. The taxpayer is in a much better position to marshall the other 40% to elect a managing Board of Directors. Under the related party provisions of the proposed regulations, however, the corporation is deemed *not* controlled by the 10% shareholder/taxpayer. *Id.*

173. *Id.*

174. Another commentator has suggested that taxpayers not test the standard "unless they particularly seek the thrill of Tax Court litigation." Cuff, *supra* note 150, at 25.

175. Rev. Rul. 83-116, 1956-1 C.B. 264.

is also case authority directly contrary to the Service's position.[176] If the Service continues to maintain its position,[177] this provision will have set up yet another trap for the unwary investor.

4. "To be Produced" Property. Again, there is no statutory authority nor legislative history for this provision. However, the provision does appear to be a flexible response to situations actually encountered in the world of real estate exchanges; namely, the common practice of a taxpayer exchanging property for land upon which the seller, or another will construct a building.[178] Nevertheless, there are some problems with these provisions.

First, the identification requirements are weak. They could be strengthened considerably to avoid confusion. What constitutes "as much detail as is practicable at the time the identification is made"[179] is much too vague. This standard provides little additional, practical guidance concerning property to be constructed than the underlying statutory requirement that property be identified.[180]

Second, the receipt rules are potential litigation traps. The proposed regulations flexibly anticipate that construction will often not be completed within the 180-day exchange period. This, by itself, will not defeat the exchange.[181] However, comparing the value of the property at the time it is received against its value when identified to determine if the received property is "substantially the same" as the identified property requires two estimates of its value: the first, at the time the property is identified, and the second at the time the property is received (but not completed). Combined with the lack of definition of "substantially the same," this provision is remarkable for its lack of specificity on an otherwise very technical point.

CONCLUSION

On the whole, the proposed regulations conform well with the statute and its legislative history where that history speaks to the specific statutory language of section 1031(a)(3). Where the regulations involve issues touched on in other provisions of the Internal Revenue Code, however, the regulations tend to be more restrictive without explicit or sufficient justification. One can only speculate as to the Service's reasons for the restrictions. The reasons will become clear only after taxpayers litigate issues relating to the restrictions

The Service was wise, however, to use the proposed regulations as a vehicle to address not only the issues raised by the statute, but also many of the issues

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176. *See* Snyder v. Commissioner, 41 T.C.M. (CCH) 1416 (1981).

177. Significantly, Revenue Ruling 83-116 was issued *after Snyder*. The Service expressly refuses to follow *Snyder* in Revenue Ruling 83-116. Rev. Rul. 83-116, 1956-1 C.B. 264.

178. Cuff, *supra* note 150, at 26.

179. Prop. Treas. Reg. § 1.1031(a)-3(e)(2)(i), 55 Fed. Reg. at 20,285.

180. *Accord* Cuff, *supra* note 150, at 27.

181. Prop. Treas. Reg. § 1.1031(a)-3(e)(3)(iii), 55 Fed. Reg. at 20,285.

raised by the practical realities of the marketplace. On the whole, the Service has responded with flexible and reasonable regulations. These regulations should go a long way to reduce existing uncertainty (and its consequent litigation) and abuse in structuring delayed exchanges.

But, the proposed regulations are in no way perfect. They could be improved considerably. Since the regulations are mere proposals, hopefully the Service will recognize potential problems and consider changing some or all of the following areas before they are published in final form.

- First, the identification rules are overly restrictive and do not reasonably reflect the realities of the marketplace. Of all the proposed rules, the Service needs to consider amending these the most.
- Second, while the safe harbors generally are a reasonable response to the issue of constructive receipt, there are some potential pitfalls in their use as well. In particular, the inconsistency between the example and the regulations concerning the receipt of cash from the accommodator and the conditions under which a standby letter of credit may validly be paid need to be addressed.
- Third, the strictness of the related party rules is questionable and should be reevaluated. The statutory authority on related parties does not support the regulations and the Service has offered no other justification for them. This is an area which is likely to create unnecessary litigation.
- Fourth, the "substantially the same" rule, while reasonable, is likely to be defined by the courts if the Service does not provide more specific guidance on the meaning of this term.
- Fifth, the "weekend rule" is simply a trap for the unwary with little justification.
- Finally, the special rules for identification and receipt of replacement property to be produced simply have not been thoroughly thought out. Hopefully, these rules will be reexamined and refined by the time the final regulations are published. Alternatively, separate regulations should be issued on these points.

Rather than unduly restrict the availability of delayed exchanges, the proposed regulations go far to make this technique a useful and practical tool for avoiding taxes on the gains on the disposition of real estate. Despite the problems, the identification rules, for example, provide flexible, practical, and simple standards which substantially improve the certainty that a particular delayed exchange will be allowed.

Even more important are the safe harbors. Until the regulations were published, the issue of constructive receipt hung over transactions like the sword of Damocles, always ready to slice through a transaction at just the point dividing the sale/repurchase transaction from the exchange transaction. In these regulations, however, the Service has managed to provide useful, practical, and industry-conforming safe harbors to bypass the issue, thus reducing uncertainty in this area almost to zero. If a taxpayer structures a transaction within the safe harbors, he is almost assured that the transaction will be accorded exchange treatment.

Thus, by substantially reducing uncertainty, the volume of exchange transac-

tions will most likely increase. Some of that increase will, of course, come from transactions that otherwise would have been sale/repurchase transactions. On the other hand, some will also come from real estate investors who were otherwise reluctant to dispose of their property because of the tax consequences. In either case, however, the quantum of funds invested will increase to the extent that the gains from the disposition of the relinquished property will not be taxed.

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* I would like to acknowledge the critical contribution of my wife, Kathy Robinson, who introduced me to section 1031 exchanges and whose expertise, resources, and support were invaluable.