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Tax Planning for Dispositions of Real Estate

Charles H. Egerton
TAX PLANNING FOR DISPOSITIONS OF REAL ESTATE

by

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Orlando, Florida

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I. Tax Planning in Perspective. Investors and business persons generally share common objectives in structuring any transaction for the disposition of real estate. These objectives, in their simplest form, usually include the maximization of the net proceeds received from the sale and, if any portion of the sale price is to be deferred, to protect against the risk of not receiving the balance of the sales price. Income taxes imposed upon the seller's gain from the sale are generally the largest cost borne by the seller in such a transaction. Consequently, a great deal of time and attention is deservedly focused upon structuring transactions in a manner that will minimize or defer income taxes to the extent legitimately possible. However, tax planners should always keep in mind that tax minimization represents only one element of the seller's ultimate objectives. Over-planning or dogged adherence to a tax plan the other side finds objectionable will often result in a lost sale and/or the exposure of the seller to a higher degree of risk that may ultimately cost the client more than the amount of the potential tax savings. This outline will focus on a number of tax planning considerations and opportunities that may be employed to minimize or defer a seller's income tax upon a disposition of real estate. However, it is important to keep in mind that we, as tax professionals, must never lose sight of the fact that our tax planning efforts should always contribute to the achievement of the client's ultimate objectives of accomplishing a sale and ultimately receiving the maximum net proceeds from the disposition.

II. Installment Reporting.

A. Historical development. Installment reporting of gains from the disposition of property has been a part of our income tax system since it was first introduced by the Revenue Act of 1926. The installment reporting provisions were enacted for the salutary purpose of enabling a seller whose sale

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1 The author expresses appreciation to H. Bryan Ives, III, Esquire, of Charlotte, N.C. for permission to reprint a portion of his material in Part III.E. of this outline.
proceeds will be fully or partially deferred until later years to pay his taxes proportionately as he receives his money. The installment sales provisions were substantially revised by the Installment Sales Revision Act of 1980 (the "Installment Sales Act"), a statutory model that was widely acclaimed both for its equity and its simplicity.

B. Overview of installment reporting provisions.

1. An installment sale is defined in §453(b)(1) as a "... disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs."

2. Under the installment reporting method, a portion of each payment received by the taxpayer must be reported as income. The portion to be recognized as income is determined by multiplying the payment by a fraction, the numerator of which is the "gross profit" realized or to be realized in the transaction, and the denominator is the "total contract price." This is referred to as the "gross profit percentage." Temp. Reg. §15A.453-1(b)(2)(i).
   b. "Total contract price" is the selling price less "qualified indebtedness" assumed or taken subject to by the buyer to the extent that such qualified indebtedness does not exceed the seller's basis. Temp. Reg. §15A.453-1(b)(2)(iii). Qualified indebtedness generally means debt encumbering the property, subject to certain limitations. See, Temp. Reg. §15A.453-1(b)(2)(iv). If qualified indebtedness assumed or taken subject to exceeds the seller's basis, such excess will be treated as an additional payment to the seller at closing. Temp. Reg. §15A.453-1(b)(iii). In summary, qualified indebtedness will not result in current taxation to the seller except to the extent that it exceeds the seller's basis in the property.
   c. If mortgage debt is incurred by a taxpayer in contemplation of a disposition of the encumbered property, which mortgage debt is
assumed or taken subject to by the buyer, such debt will not constitute "qualified indebtedness" and the entire amount of such debt will be treated as an additional payment in the year of sale. Temp. Reg. §15A.453-1(b)(2)(iv).

(1) In the absence of such a rule, a potential seller of unencumbered property might mortgage the property immediately prior to the sale. Since borrowing normally constitutes a nontaxable event, the seller would receive the funds tax free. Moreover, if the mortgage debt did not exceed the seller's adjusted basis in the property, the subsequent sale of the property subject to the mortgage would not result in an additional payment in the year of sale under §453. Thus, the seller would have cashed out part of his investment in the property, but deferred the recognition of gain attributable to such interest through manipulation of the installment reporting provisions.

d. A bona fide wrap-around mortgage will neither be regarded as qualified debt nor as an additional payment in the year of sale, even if the amount of such debt exceeds the seller's basis. See, discussion in II.G., infra.

e. "Payments" generally do not include a purchase money note received from the seller in connection with the sale, regardless of whether such purchase money debt is guaranteed by a third party. Temp. Reg. §15A.453-1(b)(3)(i). A standby letter of credit (as defined in Temp. Reg. §15A.453-1(b)(3)(iii)) will be treated as a third party guarantee. However, a purchase money note which is directly or indirectly secured by cash or a cash equivalent (e.g., a bank certificate of deposit or a treasury note) will be characterized as a payment. Temp. Reg. §15A.453-1(b)(3)(i). "Payment" also includes consideration received from the buyer in the form of foreign currency, marketable securities and notes which are either payable upon demand or are readily tradeable. Id.
(1) The Tax Court, in Estate of Mose Silverman, 98 T.C. 54, (1992) held that certificates of deposit received by the seller were not "payments" but were the equivalent of an installment obligation. The taxpayers in Silverman owned stock in a state chartered savings and loan association which was acquired in a merger by a federally chartered savings and loan association. A portion of the consideration received by the taxpayers constituted non-withdrawable fixed rate six-year certificates of deposit. Due to the fact that the taxpayers could not withdraw monies prior to the expiration of six years and their ability to pledge the certificates of deposits was also limited, the Tax Court held that they were equivalent to installment obligations.

3. A taxpayer who disposes of property in an installment sale must report his gain on the installment method unless he elects out under §453(d). The election not to report under the installment method is made by filing IRS Form 6252 with a timely filed return (including extensions) for the taxable year in which the closing takes place. Temp. Reg. §15A.453-1(d)(3)(i). Temp. Reg. §15A.453-1(d)(3)(i) also provides that a taxpayer who reports an amount realized equal to the selling price of the property (including the full face amount of any installment obligation) on his return for the year in which the sale closed will be considered to have elected out of the installment method. The election, once made, may not be revoked without the consent of the IRS. §453(d)(3).

4. A number of limitations upon the use of installment reporting are imposed including the following:

a. Sales to related parties -- Under §453(e), a taxpayer who sells property to a related party (as defined in §453(f)(1)) may use the installment method, but any amounts received upon a subsequent disposition of the property by the related party will be treated as a payment received by the taxpayer unless an exception applies. If the sale by the
related party occurs more than two years after the first sale by the taxpayer to the related party, generally the acceleration rule will not apply unless the property that was originally sold constituted marketable securities.

b. Sales of depreciable property to related party -- If depreciable property is sold to a "related party," which, for purposes of this provision, will be limited to parties described in either §1239(b) or §707(b)(1)(B), the seller will not be eligible to report on the installment method. An exception to this disallowance is available, however, if the taxpayer can demonstrate to the Service that he did not have as one of his principal purposes the avoidance of federal income taxes. §453(g)(2).

c. Sales of property subject to §§1245 and 1250 recapture -- Any recapture income resulting from the sale under §1245 and/or §1250 must be reported in the year of sale. §453(i).

d. Dealer dispositions -- As a general rule, "dealers" who are selling property held for sale to customers in the ordinary course of their trade or business will no longer be eligible for installment reporting. §§453(b)(2)(A) and 453(l). However, certain dealers in timeshare properties and residential lots may elect to utilize the installment method under certain circumstances. See, §453(l).

e. Special rules also apply under §§1274 and 483. If an adequate rate of interest is not charged, or (regardless of whether or not an adequate rate of interest is charged) if interest payments are not actually paid at least annually, the original issue discount rules will re-characterize a portion of what otherwise would be denominated as principal into interest. This may affect both the character and the timing of recognition of income attributable to these re-characterized interest payments.

f. Disposition of installment obligations will generally accelerate unreported gain, subject
to certain narrowly defined exceptions. See, §453B.

g. The pledge of certain installment obligations to secure debt of the taxpayer will also result in an acceleration to the extent provided in §453A(d). See, discussion in II.E.3., below.

C. TRA '86 changes. Not content to leave well enough alone, Congress, in search of revenues, couldn't resist tinkering with the installment reporting provisions once again.

1. The first inequity in the installment sales area identified by Congress is described in the Senate Finance Committee Report to TRA '86 as follows:

The committee believes that the ability to defer taxation under the installment sales method is inappropriate in the case of gains realized by dealers in ordinary income assets, and also with respect to gains realized on certain business or rental property, to the extent that the taxpayer has been able to receive cash from borrowing relating to its installment obligations. S.Rpt. No. 313, 99th Cong. 2d Sess. 123 (1986) (hereinafter, the "S.Rpt." or the "Senate Report").

2. In response to this perceived inequity, TRA '86 enacted the so-called "proportionate disallowance rule," which limited the use of the installment sales method on certain sales of property based on the amount of the outstanding indebtedness of the seller. TRA '86 §811, enacting former §453C. Additionally, TRA '86 required both individuals and corporations to report the full amount of any gains arising from sales of dealer real estate as well as certain sales of real estate held either in the taxpayer's trade or business or for rental purposes in computing such taxpayer's alternative minimum tax liability. In other words, for alternative minimum tax purposes, TRA '86 completely disallowed installment reporting for sales of dealer real estate as well as for certain sales of real estate held in the taxpayer's trade or business or for rental purposes.
D. **TRA '86 alternative minimum tax rules.** In addition to subjecting a taxpayer to the proportionate disallowance rule for regular tax purposes, TRA '86 also required that, in computing alternative minimum taxable income for all taxpayers (individual and corporate), the entire gain attributable to the installment sale of property which would be treated as giving rise to an applicable installment obligation for former §453C purposes had to be reported in full (i.e., no deferral of income was allowed) (See, §56(a)(6) prior to its amendment by the Revenue Act of 1987).

E. **Overview of Revenue Act of 1987 changes.** Congress, apparently realizing that it had made a mistake in passing an extremely complex law (the proportionate disallowance rule) to deal with a relatively simple abuse of pledging an installment sales contract as security for a loan, repealed the proportionate disallowance rule in the Omnibus Budget Reconciliation Act of 1987 ("OBRA"). The changes to the installment sales rules made by OBRA can be divided into two categories: (1) changes affecting use of the installment sales method by dealers; and (2) changes affecting use of the installment sales method by non-dealers.

1. **Dealer sales under OBRA.** Whereas the provisions enacted by TRA '86 dramatically reduced the benefit of the installment sales method to dealers of real and personal property by means of the proportionate disallowance rule and the alternative minimum tax, OBRA generally denies dealers (in real or personal property) use of the installment sales method altogether. §453(b)(2)(A) and §453(1). Thus, a dealer in real or personal property must recognize the full amount of gain on sale of dealer property in the year of sale even if the dealer does not receive full payment in the year of sale.

   a. The new rules disallowing the use of the installment sales method by dealers did not, however, apply to the following types of dispositions: installment sales of property used or produced in the trade or business of farming as defined in §2032A(e)(4) and 5 -- §453(1)(2)(A); installment sales of timeshare rights in residential real property for not more than six weeks per year -- §453(1)(2)(B)(ii)(I); and installment sales of residential lots if the taxpayer (or any
related person) is not to make any improvements with respect to such lot --- §453(1)(2)(B)(ii)(II). The exceptions for sales of timeshare rights and residential lots applied only with respect to sales to individuals.

b. In order for a taxpayer to utilize the installment sales method for sales of timeshare rights and residential lots under §453(1)(2)(B), the taxpayer must elect to report such sales on the installment method and to make interest payments to the Internal Revenue Service (as calculated below) for the period beginning on the date of the sale and ending on the date such payment is received. §453(1)(3). The interest is calculated by multiplying the applicable federal rate (compounded semi-annually) in effect at the time of the sale by the amount of the tax for the taxable year which is attributable to payments received during the taxable year on the installment sales obligations for which the election has been made. No interest is due for payments received in the taxable year of disposition from which the installment sale obligation arises. §453(1)(3)(B)(iii).

c. As a planning tip, dealers who sell property on an installment sales basis should plan either to: (1) receive sufficient payments on the installment sales obligation during the taxable year of the sale to enable the dealer to pay the income tax liability attributable to the sale; or (2) make sure that the purchaser's obligation to pay the installment payments is amply collateralized, guaranteed and fully negotiable so that the dealer can pledge the obligation for a loan to enable the dealer to pay the tax liability attributable to the sale.

d. The repeal of the installment sales method for dealers of real and personal property is generally effective for installment sales obligations arising from dispositions occurring after December 31, 1987. OBRA §10202(e)(2)(A).

2. Non-dealer sales under OBRA. Rather than prohibiting use of the installment sales method altogether (as was done with respect to dealers),
§453A as enacted by the Revenue Act of 1987, replaced the proportionate disallowance rule with a less harsh provision that placed certain restrictions on installment sales obligations arising from the disposition of real property used in the taxpayer's trade or business or held for the production of rental income, the sales price of which property exceeded $150,000. Such installment sales obligations were referred to as "non-dealer real property installment obligations." OBRA also repealed the provision of the Code which denied taxpayers use of the installment sales method on non-dealer real property installment obligations for alternative minimum tax purposes. Under OBRA, taxpayers were entitled to use the installment sales method with respect to non-dealer real property installment obligations for alternative minimum tax purposes.

a. The first restriction placed on non-dealer real property installment obligations by new §453A provided that to the extent the face amount of all such obligations which arose during the taxable year and which are outstanding as of the close of such taxable year exceeded $5,000,000, interest on the "deferred tax liability" attributable to such obligations must be paid to the Internal Revenue Service by the taxpayer.

(1) Query: How is the $5,000,000 threshold rule to be applied if there is a contingent purchase price? Hopefully, forthcoming regulations will address this issue. See, discussion re: contingent sales in II.H., infra.

(2) Query also: If an interest toll charge is imposed under §454A but the buyer of the property subsequently defaults, will the taxpayer be allowed to recoup the interest charge previously paid through a refund, basis adjustment or any other procedure?

b. The second restriction was that, regardless of the $5,000,000 threshold set forth above, such obligations would be subject to the pledging rules of §454A(d).

c. The deferred tax liability and pledging rules generally did not apply to installment
obligations arising from the following types of dispositions: (1) dispositions (by an individual) of "personal use property" within the meaning of §1275(b)(3) -- §453A(b)(3)(A); (2) dispositions of property used or produced in the trade or business of farming within the meaning of §2032A(e)(4) or (5) -- §453A(b)(3)(B); and (3) dispositions of timeshare rights and residential lots described in §453(l)(2)(B), provided that the interest payment rules of §453(l)(3) (rather than those of §453A) were to be applied to such installment sales obligations -- §453A(b)(A).

d. For purposes of determining whether a taxpayer had a non-dealer real property installment obligation (i.e., whether the sales price of the property exceeded $150,000), all sales or exchanges which were part of the same transaction (or series of related transactions) were treated as one sale or exchange. §453A(b)(5).

e. If a non-dealer real property installment obligation is outstanding as of the close of any taxable year, the taxpayer's tax was to be increased by the product of: (1) the "applicable percentage" of the "deferred tax liability" with respect to such non-dealer real property installment obligation; multiplied by (2) the underpayment rate in effect under §6621(a)(2) for the month with or within which the taxable year of the taxpayer ends. §453A(c)(2). The term "deferred tax liability" is defined as the product of the amount of gain with respect to a non-dealer real property installment obligation which has not been recognized as of the close of such taxable year, multiplied by the maximum rate of tax in effect under §1 or §11, whichever is appropriate, for such taxable year. §453A(c)(3). The term "applicable percentage" means, with respect to non-dealer real property installment obligations arising in any taxable year, the percentage determined by dividing the portion of the aggregate face amount of all such non-dealer real property installment obligations outstanding as of the close of such taxable year in excess of $5,000,000, by the aggregate face amount of such non-dealer real
property installment obligations outstanding as of the close of such taxable year. §453A(c)(4). The applicable percentage for any non-dealer real property installment obligation as so computed will remain constant throughout the entire period it continues to be held by the taxpayer.

f. Expressed as an equation, a taxpayer's increase in tax liability due to non-dealer real property installment obligations was calculated as follows:

\[
\text{Interest on Deferred Tax Liability} = (\text{Applicable Percentage}) \times (\text{Deferred Tax Liability}) \times (\$6621(a)(2) \text{ Underpayment Rate}).
\]

3. If any non-dealer real property installment obligation is pledged as security for any indebtedness (referred to as "secured indebtedness"), the net proceeds of the secured indebtedness are treated as a payment received on such non-dealer real property installment obligation as of the later of: (1) the time which the indebtedness becomes secured; or (2) the time the proceeds of such secured indebtedness are received by the taxpayer. §453A(d)(1). However, the amount treated as received under the pledging rules by reason of any secured indebtedness cannot exceed the excess (if any) of the total contract price under the non-dealer real property installment obligation, over any portion of the total contract price received under the contract before the secured indebtedness was incurred (including amounts previously treated as received under the pledging rules). As payments are actually received on non-dealer real property installment obligations which have been subject to the pledging rules, such amounts are recovered tax free to the extent such proceeds have already been treated as received under the pledging rules. §453A(d)(3). Additionally, the pledging rules provide that indebtedness is secured by a non-dealer real property installment obligation to the extent that payment of principal or interest on such indebtedness is directly secured (under the terms of the indebtedness or any underlying arrangements) by any interest in such non-dealer real property installment obligation. §453A(d)(4).
4. The new restrictions placed on non-dealer real property installment obligations by §453A were generally effective for installment obligations relating to dispositions occurring in taxable years beginning after December 31, 1987. OBRA §10202(e)(1). However, taxpayers having non-dealer real property installment obligations were entitled to elect to have the new rules apply in lieu of the proportionate disallowance rule for taxable years ending after December 31, 1986, with respect to dispositions and pledges occurring after August 16, 1986. §10202(e)(3). See, Notice 88-81, 1988-2 C.B. 397, for guidance on how to apply the OBRA rules to 1986 and 1987 installment sales.

5. The new pledging rules of §453A(d) generally applied to non-dealer real property installment obligations pledged to secure any secured indebtedness after December 17, 1987. Additionally, if the taxpayer elected out of the proportionate disallowance rule, the pledging rules will apply to taxable years ending after December 31, 1986. OBRA §10202(e)(3)(B).

6. The amendments allowing use of the installment sales method with respect to non-dealer real property installment obligations for alternative minimum tax purposes applied to dispositions in taxable years beginning after December 31, 1986. Presumably, the amendments made to the alternative minimum tax also apply to dispositions made after August 16, 1986, and before January 1, 1987, since, for purposes of the proportionate disallowance rule, such dispositions were deemed to have been made after December 31, 1986.


1. Both the interest toll charge and the pledge rules will now apply to any post-1988 sale (i.e., §453A will no longer be confined to non-dealer real property sales) that is otherwise eligible for installment reporting where the sales price exceeds $150,000, and, in the case of the interest charge, where the $5,000,000 threshold
is also met, except with respect to the following types of properties:

a. Property used or produced in the trade or business of farming. §453A(b)(3).

b. TAMRA repealed the exemption previously contained in the '87 Act version of §453A for personal use property. This repeal was apparently inadvertent because the Conference Report to TAMRA clearly stated that the revised rules do not apply to personal use property. Conf. Rep., Statement of the Managers 183 (10/24/88).

(1) The '89 Act corrected this error by reinstating the exemption for personal use property (as defined in §1275(b)(3)). See, new §453A(b)(3)(A) which is effective as if included in TAMRA.

c. Timeshares and residential lots with respect to which the taxpayer has elected to report on the installment basis under §453(1)(2)(B).

2. Prior to the '89 Act, §453A was unclear with respect to the deductibility of the interest payable under that section. The Committee Reports, however, stated that such interest was to be treated as interest on an underpayment of tax. See, Conf. Comm. Rpt., H.R. Rep. 100-495, 930 (12/21/87). This treatment assured that the interest would be classified as "personal interest" under §163(h). See, Temp. Reg. §1.163-9T(b)(2). The '89 Act confirms this treatment by the addition of new §453A(c)(5). Apparently the toll charges could also be subject to the interest capitalization rules of §263A(4).

3. Section 453A(c)(6) was added by TAMRA to authorize the Commissioner to issue regulations to prevent the avoidance of the rules of §453A through the use of related persons, pass-through entities and intermediaries and to also provide rules to assure that the sale of an interest in a pass-through entity (a partnership or an S corp.) will be treated for purposes of §§453 and 453A as a sale of the seller's proportionate share of the assets of the entity.
G. Wraparound mortgages.

1. Facts: Taxpayer ("TP") owns real property ("Value Land") with a basis of $500,000 and which is encumbered by a mortgage with an outstanding principal balance of $700,000 and bearing interest at 8% per annum ("Original Mortgage"). TP receives an offer from Buyer to acquire Value Land for $12,500,000, payable $2,500,000 down with the balance of $10,000,000 payable in the form of a purchase money note and mortgage payable over seven years at 12% per annum, with interest only for the first two years and the balance payable over five years. The purchase money note and mortgage "wrap around" the $700,000 Original Mortgage (i.e., TP will continue to be responsible for payment of principal and interest on the Original Mortgage), and Buyer will assume no responsibility thereunder (and will be indemnified by TP against the Original Mortgage).

2. General considerations:

   a. From a non-tax prospective, the wraparound purchase money mortgage provides TP the opportunity to continue to benefit from the favorable terms of the Original Mortgage including the 8% interest rate (thereby enjoying the benefit of the "spread" between the 12% interest rate paid by Buyer under the purchase money note and mortgage versus the 8% rate TP must pay on the Original Mortgage). In addition, TP's "equity" in Value Land will be considerably greater than Buyer's for most of the term of the new purchase money note and mortgage. The use of a wraparound mortgage will provide TP with additional security that payments will be made on the Original Mortgage on a regular basis and that no events will occur that would give the holder of the Original Mortgage the right to foreclose or otherwise accelerate.

   b. The principal tax issue is whether Buyer will be deemed to have acquired Value Land "subject to" the $700,000 balance of the Original Mortgage. The consequences stemming from the resolution of this issue are significant to TP.
(1) If the property is determined to have been conveyed "subject to" the Original Mortgage, TP will be deemed to have received an additional payment in the year of sale equal to the excess of the $700,000 principal balance of the Original Mortgage over the adjusted basis in Value Land of $500,000, or $200,000. Temp. Reg. §15A.453-1(b)(3)(i). In addition, the gross profit percentage TP must apply to the payments received in the year of sale will be increased.

(2) The Service, in Temp. Reg. §15A.453-1(b)(3)(ii) provided that any conveyance of property which is encumbered by a prior liability that is purportedly "wrapped around" by a new purchase money mortgage, will be deemed to have been conveyed subject to the existing debt.

(3) Temp. Reg. §15A.453-1(b)(3)(ii) requires the computation of a gross profit percentage which is to be applied to payments in the year of sale (computed in the normal fashion) and a separate gross profit percentage for the wraparound note and mortgage.

The calculations called for under the Regulations are as follows:

<table>
<thead>
<tr>
<th>Selling Price</th>
<th>$ 12,500,000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Contract Price</strong></td>
<td>$ 12,500,000</td>
</tr>
<tr>
<td><strong>- 500,000</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Selling Price</strong></td>
<td>= $ 12,000,000</td>
</tr>
<tr>
<td><strong>Mortgage taken subject to</strong></td>
<td></td>
</tr>
<tr>
<td><strong>but not exceeding basis</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Gross Profit</strong></td>
<td>$ 12,500,000</td>
</tr>
<tr>
<td><strong>- 500,000</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Selling Price</strong></td>
<td>= $ 12,000,000</td>
</tr>
<tr>
<td><strong>Basis</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Gross Profit</strong></td>
<td>$ 12,000,000</td>
</tr>
<tr>
<td><strong>Percentage</strong></td>
<td>12,000,000</td>
</tr>
<tr>
<td><strong>12,000,000</strong></td>
<td>= 100%</td>
</tr>
<tr>
<td><strong>Payment in year</strong></td>
<td>$ 2,500,000</td>
</tr>
<tr>
<td><strong>of sale</strong></td>
<td>+ 200,000</td>
</tr>
<tr>
<td><strong>Cash</strong></td>
<td>+ 200,000</td>
</tr>
<tr>
<td><strong>Excess of mortgage over</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Basis</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Payment in year</strong></td>
<td>$ 2,700,000</td>
</tr>
<tr>
<td><strong>of sale</strong></td>
<td>- 15 -</td>
</tr>
</tbody>
</table>
Taxable gain in year of sale $ 2,700,000  

\[ \begin{align*} \text{Gross profit percentage} & = \frac{2,700,000}{1.00} = 2,700,000 \end{align*} \]

The calculations with respect to the wraparound note and mortgage are as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis in wrap note</td>
<td>$ 500,000</td>
</tr>
<tr>
<td>+ Gain recognized in year of sale</td>
<td>$ 2,700,000</td>
</tr>
<tr>
<td>- Cash received</td>
<td>$ 2,500,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$ 700,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis in Value Land</td>
<td><strong>$ 10,000,000</strong></td>
</tr>
<tr>
<td>- Face amount</td>
<td><strong>$ 700,000</strong></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$ 9,300,000</strong></td>
</tr>
</tbody>
</table>

Gross profit percentage for wrap note = \( \frac{9,300,000}{10,000,000} = 93\% \)

(4) TP's contention is that the Original Mortgage was neither assumed nor taken subject to. Under this approach the computations would be as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling price</td>
<td>$ 12,500,000</td>
</tr>
<tr>
<td>Contract price</td>
<td>$ 12,500,000</td>
</tr>
<tr>
<td>(no reduction for Original Mortgage)</td>
<td></td>
</tr>
<tr>
<td>Gross profit</td>
<td>$ 12,500,000</td>
</tr>
<tr>
<td>(selling price)</td>
<td></td>
</tr>
<tr>
<td>- Basis</td>
<td>$ 500,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$ 12,000,000</strong></td>
</tr>
</tbody>
</table>

Gross profit = \( \frac{12,000,000}{12,500,000} = 96\% \)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payments in year of sale</td>
<td>$ 2,500,000</td>
</tr>
<tr>
<td>Taxable gain in year of sale</td>
<td>$ 2,500,000</td>
</tr>
<tr>
<td>x .96</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$ 2,400,000</strong></td>
</tr>
</tbody>
</table>

- 16 -
(5) Comparison of timing of recognition of gain:

<table>
<thead>
<tr>
<th>Year</th>
<th>IRS Approach</th>
<th>Taxpayer's Approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$2,700,000</td>
<td>$2,400,000</td>
</tr>
<tr>
<td>2</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>3</td>
<td>1,860,000</td>
<td>1,920,000</td>
</tr>
<tr>
<td>4</td>
<td>1,860,000</td>
<td>1,920,000</td>
</tr>
<tr>
<td>5</td>
<td>1,860,000</td>
<td>1,920,000</td>
</tr>
<tr>
<td>6</td>
<td>1,860,000</td>
<td>1,920,000</td>
</tr>
<tr>
<td>7</td>
<td>1,860,000</td>
<td>1,920,000</td>
</tr>
<tr>
<td>Total Gain</td>
<td>$12,000,000</td>
<td>$12,000,000</td>
</tr>
</tbody>
</table>

3. Status of the law with respect to wraparound mortgages. The tax treatment of wraparound mortgages has, until recently, been an unsettled issue.


b. Later cases involving purported wraparound mortgages held for IRS, but in each instance the Court sidestepped the principal issue and held that, on the facts before it, the purchaser had actually assumed or taken subject to the pre-existing mortgage. See, Voight v. Commissioner, 68 T.C. 99 (1977), aff'd per curiam, 614 F.2d 94 (5th Cir. 1980); Waldrep v. Commissioner, 52 T.C. 640 (1969), aff'd per curiam, 428 F.2d 1216 (5th Cir. 1970); and Goodman v. Commissioner, 74 T.C. 684 (1980).

c. After passage of the Installment Sales Act, a substantial portion of the installment reporting rules was changed. The Service took advantage of this situation and included the anti-wraparound mortgage provision found in Temp. Reg. §15A.453-1(b)(3)(ii) discussed above. However, the Service's position in this regard was suspect from the outset.
because the installment sale provisions added by the Installment Sales Act did not alter the rules regarding the computation of "gross profit percentage." The Service's proposed regulation, as it applies to wraparound mortgages, has been criticized on several grounds including the following:

(1) It utilizes two separate gross profit percentages which seems to be taking great liberties with the language in the statute.

(2) There is an ambiguity in the Service's definition of "qualifying indebtedness" which may cause problems for real estate developers who refinance a construction loan with a permanent, "take out" loan.


(4) In Hunt v. Commissioner, 80 T.C. 1126 (1983), the Tax Court for the first time dealt with a pure wraparound mortgage (which did not involve a de facto assumption or taking subject to as in Voight and Goodman) and held for the taxpayer. The Court held that the Stonecrest line of cases, which involved conditional sales, also applies to wraparound mortgages. The facts of Hunt pre-date the Installment Sales Act and the Court specifically reserved judgment on what impact, if any, the Service's Temporary Regulation would have on its decision if it were presented with similar facts arising after 1980.

(5) In Professional Equities Corporation v. Commissioner, 89 T.C. 165 (1987), the Tax Court held that Temp. Reg. §15A.453-1(b)(2)(ii) was invalid and was inconsistent with the Stonecrest line of cases. The Commissioner subsequently announced his acquiescence in the
Professional Equities decision. 1988-2 C.B. 1. However, it is important to note that the court was not required to specifically address the issue of mortgage in excess of basis. In dicta contained in footnote 17 of the opinion, the court stated that it seemed reasonable to treat mortgage in excess of basis as a payment in the year of sale. This comment appears inconsistent with the Stonecrest line of cases and is also inconsistent with Hunt in which the balance of the underlying mortgages exceeded the taxpayers' basis in the property but the Tax Court did not require the excess to be treated as a payment in the year of sale.

(6) The holding in Professional Equities was followed in Vincent E. Webb, 54 T.C.M. 443 (1987). However, despite its acquiescence in Professional Equities and the Tax Court's subsequent decision in Webb, the Service continues to advise taxpayers that they must treat the underlying debt in a wraparound mortgage as having been assumed or taken subject to. See, IRS Pub. 537, "Installment Sales" (issued for use in preparing 1989 tax returns). Moreover, in Robert E. Kline, 57 T.C.M. 822 (1989), the Tax Court followed its prior reasoning in Goodman to strike down a purported wraparound mortgage. The primary reason cited by the Tax Court for its holding (and as a basis for distinguishing Professional Equities) was that the payments on the wrap note in Kline were required to be made to a collection agent who was obligated to apply the payments first in discharge of the underlying mortgages and thereafter to the taxpayer. Thus, in the view of at least one judge of the Tax Court (Kline was a Memorandum Decision) the use of a collection agent to secure payment of the underlying mortgages will be treated as a de facto assumption or conveyance subject to the underlying debt.
H. Sales with contingencies.

1. Property owners who sell land to developers are frequently torn between the desire to engage in an outright sale of their property or to enter into a joint venture with the developer/purchaser to develop the property and obtain a greater return. In an attempt to obtain the best of both worlds, some sellers attempt to sell their properties for a fixed price coupled with an additional contingent price "kicker" equal to a fixed or variable percentage of the proceeds derived by the developer/purchaser from resale of the land. There are a number of variations of this approach. For example, the participation interest might be payable from net profits (rather than from net sales proceeds); it might be subject to a ceiling (e.g., 25% of net sales proceeds but not to exceed an aggregate amount of $500,000); or the participation might terminate or phase out over a specified period of years. The objective of the seller in each of these instances is to lock in a guaranteed minimum selling price for his land while at the same time participating in the upside potential from subsequent development of the property. Equity participation sales give rise to a number of tax issues.

   a. Sale versus partnership (or, alternatively, part sale/part partnership).

   b. If the transaction is treated as a sale, will installment reporting be available for the contingent portion of the purchase price?

   c. If installment reporting is available, how does the interest toll charge of §453A(a)(1) apply to the contingent portion of the sales price?

2. If the sale for a fixed price plus an equity kicker is recognized as a sale for federal income tax purposes, the application of the installment reporting rules of §453 to the contingent portion of the purchase price is governed by a special set of rules.

   a. Prior to Installment Sales Act, if a purchase price was contingent, installment sale reporting was not available but the seller was entitled to recover basis against the
first proceeds received. Gralapp v. Commissioner, 458 F.2d 1158 (10th Cir. 1972); In Re Steen, 509 F.2d 1398 (9th Cir. 1975). The determination of whether the selling price was contingent was to be made as of the end of the taxable year in which the closing took place. See, Rev. Rul. 76-109, 1976-1 C.B. 125.

b. The Installment Sales Act added §453(j) to the Code which instructs the Treasury to issue new regulations which, among other things, "... shall include regulations providing for ratable basis recovery in transactions where the gross profit or the total contract price (or both) cannot be readily ascertained." §453(j)(2).

(1) This determination is to be made at the end of the taxable year of closing. Temp. Reg. §15A.453-1(c)(1).

(2) If the contract is deemed to have a "maximum stated selling price," the selling price for purposes of §453 will be deemed to be the maximum price payable if all contingencies are met. If price ultimately payable is less than this amount, gross profit ratio will be recomputed. Temp. Reg. §15A.453-1(c)(2)(i)(A).

(3) If the selling price is not determinable at the end of the taxable year of closing (i.e., no maximum stated selling price) but the maximum period over which payments may be received is determinable, the seller's basis (inclusive of selling expenses) must be prorated evenly over the maximum pay-out period. Temp. Reg. §15A.453-1(c)(3)(i). If the payment in any taxable year is less than the basis allocable for that year (or if no payments are made in such year), no loss will be allowed unless such year is the final year of payment, and the basis allocable to such year will be carried forward to the next succeeding taxable year. Id.

(4) If there is neither a maximum stated selling price nor a fixed pay-out period,
and if the transaction qualifies as a sale for tax purposes, the seller's basis will be recovered in equal annual increments over a period of 15 years, commencing with the taxable year in which the closing takes place. Temp. Reg. §15A.453-1(c)(4). If no payment is received in a year, or if the payments received are less than the basis allocable to such year, no loss will be allowed (unless the remaining debt is determined to be worthless), but basis will be carried over to the next succeeding year.

(5) In each of these three instances provision is made for alternative treatment if the seller can establish to the satisfaction of the Commissioner that the general rule would substantially and inappropriately defer recovery of the seller's basis. See, Temp. Reg. §15A.453-1(c)(7). The seller must apply for and receive a ruling from the Service prior to using an alternative method of basis recovery. Temp. Reg. §15A.453-1(c)(7)(ii).

c. §453A(a)(1) imposes an interest toll charge upon the deferred tax liability inherent in certain installment notes (see, discussion under II.E. and F.). Will the toll charge be levied not only with respect to the deferred gain on the fixed portion of an installment obligation but also on the contingent portion? If so, will be deferred tax liability be based upon the maximum stated sales price? Cf. Temp. Reg. §15A.453-1(c)(2)(i)(A). If the regulations ultimately take this approach, will the taxpayer be able to recoup part of the interest payable with respect to the contingent portion if he ultimately receives less than the maximum amount due under the contingency? Alternatively, will a cumulative toll charge be levied as payments under the participation feature become fixed and determinable? The legislative history of §453A suggests that regulations be issued to deal with the application of §453A to contingent price sales (see, Conf. Rpt., Omnibus Budget Reconciliation Act of 1987, 1987-3 C.B. 193,
210), but no regulations have been proposed as of the date of this outline.

d. In the case of a contingent price sale, even if interest is payable regularly at a rate which exceeds the applicable federal rate with respect to the fixed portion of the installment obligation, the absence of an interest payment obligation applicable to the contingent portion will result in original issue discount ("OID"). See, generally, §§1272 through 1275. In the case of a sale of real estate, the installment obligation will be deemed to have been issued for non-publicly traded property and the rules of Prop. Reg. §1.1275-4(c) will apply. Under these rules, the non-contingent payments will be separated from the contingent payments and will be treated as two separate debt instruments for purposes of applying the OID rules. Prop. Reg. §1.1275-4(c)(1).

(1) The rules governing the contingent payments due under the installment obligation are found in Prop. Reg. §1.1275-4(c)(3). Under this section, the portion of each payment due under the participation feature that is treated as interest will be includable in the income of the taxpayer, and will be treated as a payment of interest by the purchaser, in their respective taxable years when the amount of the payment becomes fixed. Prop. Reg. §1.1275-4(c)(3)(i). Each payment under the participation feature of the installment obligation will be treated as consisting of: (a) a payment of principal in an amount equal to the present value of the payment, determined by discounting such payment at the applicable federal rate from the date the payment becomes fixed to the issue date of the note, and (b) the payment of interest in an amount equal to the excess of the total amount of such payment over the amount treated as principal under (a) above.

III. Options.

A. General. Options are frequently used in real estate transactions as an alternative to a binding contract.
The holder of the option ("optionee") desires to tie up property for a given period of time for a fixed price, but retain the flexibility to walk from the deal if the circumstances are not right. In addition, an option does not constitute a debt or obligation of the optionee until exercised and, thus, need not be reflected on the optionee's financial statement as a liability. This can be a very significant point in these days of highly restrictive lending practices in the real estate industry. The landowner/grantor of the option ("optionor") probably would prefer a binding contract to sell the property (but not always, as will be discussed below), but is willing to grant an option to optionee in exchange for a significant option payment. In most cases the option payment will be applied against the purchase price if exercised, but will be forfeited to the optionor if the option lapses.

B. **Rolling options.** X owns a large tract of undeveloped land consisting of approximately 4,000 acres which has been in X's family for three generations. The land is now ripe for development and X has received several overtures from developers to acquire his property for as much as $20,000,000. However, all offers received thus far would have required X to hold a substantial purchase money mortgage and to subordinate to the purchaser's development loans. X has been leery of these proposals both because of the economic risks involved and because of the problems associated with installment reporting after TRA '86.

Recently X received an innovative proposal from a major developer ("developer") with a substantial net worth and a proven track record. Developer has offered to acquire X's property in a series of four "rolling options." Under this approach, most of X's property would be divided into four separate parcels which would be designated as "Option Parcels 1 through 4." The balance of the property would be earmarked for development into a golf course, tennis courts, an entry way and a principal access road that would service the entire property (the "Amenities Properties").

Developer would initially pay X $1,000,000 as consideration for an option to purchase Option Parcel 1 and the Amenities Properties for a total purchase price of $5,000,000, which option would remain open for a period of 18 months. The 18-month period is designed to enable developer to pursue and obtain the necessary permits and approvals from federal, state
and local governmental agencies to develop the property. If the option is exercised, the $1,000,000 option monies will be applied against the purchase price for Option Parcel 1 and the Amenities Properties. If the option lapses, the money would be forfeited.

The purchase prices for Option Parcels 2 through 4 would also be agreed upon in advance as well as the time and sequence that such options would be exercisable. The prices would be negotiated and would take into account the fact that X must hold these properties off the market during the applicable option periods and that the property would appreciate in value both because of inflation and due to development of the contiguous properties.

At the time of exercise of each of Option Parcels 1 through 3, developer would also be required to pay an additional $500,000 to X as consideration for the remaining options, which monies would also apply against the purchase prices of such parcels if exercised or would be forfeited if the options were allowed to lapse. The purchase price for each Option Parcel would be payable in cash at closing.

This proposal provides developer with downside protection since he retains the ability to walk away from the project at any time before fully exercising all of his options and thereby limiting his investment to the properties previously purchased plus any forfeitable option monies paid for future options. Developer has also been advised by his accountants that any costs associated with future options (i.e., options that have not yet been exercised) need not be reflected as debts on his balance sheet since there is no obligation for him to pay these amounts until the options are exercised.

Although X is called upon to assume an additional degree of economic risk under this proposal, there are several aspects of the offer which appeal to him. First, the total purchase price for X's properties (consisting of the aggregate prices of Option Parcels 1 through 4 together with the Amenities Properties) is significantly higher than the prices offered by other developers which is attributable (in part) to the fact that X will be required to hold his property off the market for a substantial period of time. Under developer's offer, X will be given the right to approve all preliminary and final land plans as well as overall development plans since these plans would
impact the value of X's remaining properties if one or more of the options are not exercised. Further, even if developer allowed one or more options to lapse, presumably the value of any property that X would be left with would be enhanced in value by reason of the development of the contiguous properties. Finally, there are some significant tax advantages to X inherent in this proposal which will be discussed below.

1. Despite the fact that X will have unrestricted use of the $1,000,000 of option monies from the point in time that he receives them, he will not be taxed on these monies until the options to which they relate are either exercised or lapse. See, Virginia Iron, Coal & Coke Co. v. Commissioner, 37 B.T.A. 195 (1938), aff'd, 99 F.2d 919 (4th Cir. 1938), cert.denied, 307 U.S. 630; Commissioner v. Dill Co., 294 F.2d 291 (3rd Cir. 1961); Kitchin v. Commissioner, 340 F.2d 895 (4th Cir. 1965); Koch v. Commissioner, 67 T.C. 71 (1976); and Hicks v. Commissioner, 37 CCH T.C.M. 1540 (1978). The reason behind these rulings is that the taxability of the payments cannot be determined until the options either lapse or are exercised.

a. If an option is exercised and the option monies are applied against the purchase price, the monies will be treated as having been received in a sale or exchange of the option properties. §1234(a)(1); Temp. Reg. §1.1234-1(a). Even if the option monies are not applied against the purchase price, the Tax Court in Koch v. Commissioner, 67 T.C. 71 (1976) held that the same rule applies.

b. If the option lapses, the option monies must be reported by the optionor (X in this case) in his taxable year in which the lapse occurred and such amounts would be ordinary income. Temp. Reg. §1.1234-1(b); Rev.Rul. 57-40, 1957-1 C.B. 266.

2. If the rolling option transaction is properly structured and constitutes a true series of options (see, discussion under III.E.3. infra), the installment sale provisions, including the new interest toll charges and pledging rules added by §453A, should not apply. Moreover, to the extent that any depreciation recapture may be inherent in the property under either §1245 or
§1250, the acceleration of gain attributable to this depreciation recapture under §453(i) would also not apply.

3. Since X's property has been held by him for investment purposes, all of the gain from the sale of the property should be taxed as long term capital gains. The Internal Revenue Service, however, may argue that a portion of the option prices should be re-characterized as ordinary income on the grounds that disguised interest is built into these option prices.

a. The Service has argued that option payments are tantamount to interest and should be taxed as such, but this position was rejected by the Tax Court. See, Koch v. Commissioner, 67 T.C. 71 (1976).

b. The original issue discount rules of §§1271 through 1275 should not apply since a true option contract would not constitute a "debt instrument" as defined in §1275(a)(1). See, §1274(a). In Koch, supra, the Tax Court found that an option contract does not constitute a "debt" (67 T.C. at 82, 83), and this rationale would also seem to negate the presence of a "debt instrument."

C. Estate planning opportunities. If X is an individual, the rolling option approach also presents potential estate planning advantages in addition to income tax advantages discussed above. For example, if X's properties are acquired by the developer/purchaser in a straight sale (as opposed to a rolling option approach), X would receive an installment note for a portion of the purchase price. This installment note would be treated as "income in respect of a decedent" ("IRD") under §691 upon the subsequent death of the seller prior to the full collection of the note. Thus, the seller's estate would be required to pay estate taxes on the value of the installment note and, most importantly, the decedent's heirs would also inherit the decedent's income tax liability with respect to the unpaid balance of the installment note. See, §1014(c). However, structuring the transaction as a series of rolling options can eliminate the income tax problems that the heirs would otherwise inherit. The properties that are subject to options that have not yet been exercised at the date of death will be included in X's estate and the values will probably
be tied, at least in part, to the option prices which may eliminate the necessity of obtaining the expensive appraisals for estate tax purposes. X's heirs would also be entitled to a new "stepped-up basis" under §1014 for the portions of the property subject to the unexercised options which will enable them to subsequently sell these properties if the options are exercised without the necessity of paying income taxes (because the sales prices will be exactly equal to their tax bases).

D. Use of options to accomplish exchanges of property.

1. Reverse exchange. X wants to exchange his low basis property ("relinquished property") for other property ("replacement property") and defer recognition of unrealized gain in the relinquished property under §1031. X has identified replacement property but does not yet have a buyer for the relinquished property. Owner of replacement property is unwilling to hold it off the market until X has found a buyer for X's relinquished property and insists that X commit now to acquire the replacement property. X does not want to commit to acquire the replacement property without having located a buyer for the relinquished property because if he disposes of the relinquished property in a taxable transaction he will not have sufficient funds to acquire the replacement property. If X acquires the replacement property prior to disposing of his relinquished property the disposition of his relinquished property will not qualify for §1031 treatment even though, for example, the purchaser of the relinquished property pays the purchase price directly to the seller of the replacement property.

a. The preamble to the recently promulgated deferred exchange regulations states as follows:

"... the Service has determined that the deferred exchange rules of section 1031(a)(3) do not apply to reverse-Starker transactions. However, the Service will continue to study the applicability of the general rule of section 1031(a)(1) to those transactions."
b. X could buy an option to acquire the replacement property, giving the owner of the replacement property sufficient forfeitable option consideration to induce him to keep the replacement property off the market. The option period will be set to allow X sufficient time to find a buyer for his relinquished property.

2. Deferred exchange. X has a buyer for the relinquished property, but has not yet located replacement property. X is afraid the buyer will walk if the deal is not finalized. Nevertheless, when X transfers the relinquished property both the 45-day identification period and the 180-day exchange period of §1031(a)(3) begin to run. X wants to preserve the deal with his buyer without causing the time periods to commence. Thus, rather than transferring the relinquished property, X gives his buyer an option to purchase it which would contain terms requiring the buyer to cooperate with X in effecting a tax free exchange.

E. When an option to acquire property is the tax equivalent of an acquisition.

1. In each of the examples discussed in B, C, and D, above, the optionor would prefer an outright sale or a binding and specifically enforceable contract, but in order to postpone realization settles for an option. The optionor nevertheless wants as much assurance as possible that the option will be exercised and the sale will close. Thus, in the case of the reverse exchange, X's seller wants assurance that X will purchase the replacement property. In the deferred exchange, X wants assurance that the buyer of the relinquished property will in fact buy it. In the deferral until death, the heirs want assurance that the buyer will buy the property after X's death. In the rolling option case, the optionor wants assurance that the developer will take all of the property.

2. The option can contain a number of provisions to give the optionor comfort as to the eventual exercise in closing, including:

   a. Requiring payment of a large amount (relative to the value of the property) of forfeitable option consideration.

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b. Encouraging exercise in the case of the rolling option by setting uniform option prices for the various parcels, but requiring the optionee to take down the less valuable parcels first.

c. Encouraging exercise by requiring the optionee to first buy a land locked portion of the property and requiring him to construct an access road or extend utilities to that portion, thus benefitting the remaining parcel if he fails to exercise the entire option.

The question is, of course, how far can you go toward assuring exercise of the option and the closing of the acquisition of the property.

3. Framework for analysis.

a. §1001. The issue in the case of the rolling option, reverse exchange and deferred exchange is whether the granting of the option is in substance the "sale or disposition" of the underlying property pursuant to §1001. In cases in which the parties purposefully cast their transaction in such a form so as to avoid a "sale or disposition," the touchstone for analysis is whether sufficient benefits and burdens of ownership have passed so that the transaction is in substance a sale or disposition.

b. The issue in connection with the discussion of the estate planning opportunities is whether at the date of death of the optionor the remaining purchase price with respect to the option property constituted "amounts to which a decedent was entitled as gross income but which were not properly includable in computing his taxable income for the taxable year ending with the date of his death or for a previous taxable year under the method of accounting employed by the decedent." Reg. §1.691(a)-l(b).

4. Guidelines for structuring options and avoiding realization.

a. It is abundantly clear that the granting of an option, nothing else appearing, is not a sale or other disposition of the underlying
property pursuant to §1001. Helvering v. San Joaquin Fruit and Investment Co., 197 U.S. 496 (1936); Rev. Rul. 78-182, 1978-1 C.B. 265 (CBOE puts and calls); Rev. Rul. 84-121, 1984-2 C.B. 168 (premature disposition under §1031 with option consideration equal to 5% of fair market value on option date granted).

b. It is less clear, but almost certainly the case, that the mere granting of an option by the decedent prior to death, which was unexecuted at death, does not give rise to IRD upon the post-death exercise of and closing on the option. Acker, "Income in Respect of a Decedent," 32-3rd Tax Mgmt. Portfolio A-34. However, if the decedent entered into a contract to sell the property prior to death, at the time of death most of the material conditions to the closing have been satisfied, the post-death closing of the contract will result in IRD. This may be true even if the contract was a liquidated damages contract not specifically enforceable by the decedent or his estate and thus the economic equivalent of an option. Trust Co. of George v. Ross, 393 F.2d 694 (5th Cir. 1967).

c. Despite the general rules of a. and b. above, only the most naive would take complete comfort that realization or IRD does not arise merely because of the labeling of the transaction as an option. Thus, for example, if an owner of raw land granted a currently exercisable, freely transferable, recordable option to an optionee in exchange for option consideration equal to 100% of the fair market value of the raw land which consideration would be forfeited if the optionee did not exercise and close and which option consideration would be applied in full satisfaction of the purchase price if the optionee elected to close, the owner will most certainly be viewed as having sold the land when the option was granted.

d. The analysis under §1001 is generally to determine whether sufficient "benefits and burdens" have passed, while the analysis under §691 is generally whether the decedent had a right or entitlement to the income. Clearly the "entitlement" analysis is
different from, and much looser than, a constructive receipt analysis or merely determining that the decedent had the legal right to demand the income. IRD, by definition, can only arise if there was no realization of income prior to death. Thus, IRD can arise only if the decedent was not in constructive receipt and only if the benefits and burdens did not pass prior to death. Thus, if the rights that decedent had at the time of death do not give rise to IRD, then a fortiori those rights should not give rise to $1001 sale or exchange treatment. In other words, if under the IRD cases the decedent did not have sufficient entitlement at his death to cause the post-death closing to result in IRD, then one can rest assured that these rights are not sufficient to trigger $1001 realization.

e. In the case of a currently exercisable, freely transferrable, recordable option the optionee has all of the economic benefits of ownership except current possession, and he can obtain current possession merely for the asking. Thus, the principal focus in analyzing options under §1001 should be the extent to which the optionor can transfer the burdens of ownership to the optionee without economically triggering a "sale or disposition." Economically, the burdens of ownership would consist of the current out-of-pocket carrying costs (taxes and insurance) and, probably much more importantly, the risk of decline in fair market value between the option is granted and the time of closing.

Another burden of the ownership of legal title or possession, but less acceptable to economic analysis, would be environmental liability. However, presumably before an optionee would place forfeitable option consideration at risk the optionee would have convinced himself that the exposure was small, or if the property did not pass an environmental audit that the option consideration would be returned.

The optionee receives or assumes burdens of ownership to the extent he pays consideration for the option that will be forfeited if he
fails to close. Whether or not the option consideration is credited toward the purchase price if closing does occur is irrelevant in this analysis, because regardless of what the option agreement says, the option consideration is, in economic effect, part of the purchase price.

f. Based upon Rev. Rul. 84-121, supra, it would seem that forfeitable option consideration equal to or less than 5% of the fair market value of the underlying property on the date the option is granted is "safe." Based upon common sense, forfeitable option consideration equal to 100% of the fair market value will result in a current sale for tax purposes.

g. In addition to forfeitable option consideration paid in cash, the analysis must include the value of other inducements flowing from the optionee to the optionor, such as those described in III.E.2. above.

h. Based upon the foregoing, a reasonable framework for analysis of the §1001 sale or disposition issue would be to compare the ratio of forfeitable option consideration plus the fair market value of other consideration flowing from the optionee to the optionor to the fair market value of the underlying property. The greater the ratio, the greater the burdens of ownership that have passed to the optionee and the greater the corresponding risk that the option is the equivalent of a "sale or disposition."

i. Post-grant, but pre-closing, occurrences that are within the control of the parties should also be relevant. If, for example, the optionee is required to post additional forfeitable option consideration during the option period, the ratio would have to be re-examined at that time based upon the then fair market values. Perhaps closing on one piece of a rolling option should also trigger re-examination of the ratio based upon the remaining option consideration and the then values. Nevertheless, the mere post-grant, pre-closing decrease in fair market value of the underlying property, which would increase the ratio and mean at that point in time the
optionee has a greater percentage of the burdens of ownership, should not result in a de facto sale. How high the allowable ratio should go will presumably depend upon how susceptible the underlying property is to post-grant decreases in value. For example, the value of raw land might depend on rezoning or a new highway which, in the absence of other circumstances, should result in a higher allowable ratio than would (for example) improved real property which is 100% leased to credit where the tenants on a long term basis.

IV. Like Kind Exchanges of Real Properties.

A. Overview. Section 1031 provides an exception to the general rule of §1001(c) that gains or losses arising from the sale or exchange of property are to be recognized for tax purposes. Nonrecognition of gain or loss is provided for under §1031 in the case of exchanges of "like kind properties" (other than stocks, securities, partnership interests and similar properties, and other than "dealer properties" and properties held primarily for sale) which are held for productive use in a trade or business or for investment. §1031(a)(1) and (2). Section 1031 is frequently employed in real estate transactions, although its use is not confined to real property, in order to defer taxes on disposition. If a taxpayer sells property at a gain, his ability to acquire replacement property is limited because he has only net, after-tax proceeds to reinvest. On the other hand, if the taxpayer can arrange to effect a qualifying exchange of properties under §1031 he is able to acquire replacement properties utilizing the full purchasing power of pre-tax dollars. Moreover, the recent increases in the capital gains rates coupled with the lengthening of depreciation periods for real property have perhaps made tax deferral under §1031 even more valuable than before.

1. Section 1031 is a deferral provision. Just as in the case of most deferral provisions under the Code, §1031(d) exacts a price for nonrecognition of gain in the form of a basis adjustment. See, discussion under IV.C.5., below.

2. The provisions of §1031 are not elective. If the conditions of §1031 are met, nonrecognition is mandated which sometimes catches unwary taxpayers when a loss rather than a gain is realized in the
transaction. §1031(c); see, United States v. Vardine, 305 F.2d 60 (2d Cir. 1962).

B. Legislative history.

1. Pre-1921 law. Prior to 1921 all exchanges of tangible properties, even though they were of "like kind," were treated as taxable transactions. Revenue Act of 1918, §202(b).

2. Statutory predecessors of §1031. The Revenue Act of 1921 created a special nonrecognition rule for exchanges of property not having a "readily realizable market value." Moreover, even if such property had such an ascertainable market value, nonrecognition treatment was still accorded if the property acquired was of "like kind or use" to the property relinquished and if the relinquished property was held "... for investment, or for productive use in trade or business (not including stock in trade or other property held primarily for sale) ..." Revenue Act of 1921, §202(c). In 1923 the statute was amended to preclude the availability of nonrecognition treatment for exchanges of stock and securities and in 1924 it was further amended to delete the "readily realizable market value" provision.

3. Legislative intent. One court has focused on the "readily realizable market value" standard originally incorporated in the 1921 edition of the statute and determined that the underlying legislative rationale for nonrecognition was to avoid administrative difficulties in valuing properties for the purposes of computing gain or loss. Century Electric Co. v. Commissioner, 192 F.2d 155, 159 (8th Cir. 1951), cert. denied, 342 U.S. 954 (1952). However, the better view seems to be that the statute was intended to provide nonrecognition in instances where the taxpayer continues his investment in essentially the same kind of property as the property disposed of and his gain or loss is merely "theoretical." H.R. Rept. No. 704, Revenue Act of 1934, 73d Cong., 2d Sess., 1939-1 (Pt. 2) C.B. 554, 564; Jordan Marsh Co. v. Commissioner, 269 F.2d 453, 456 (2d Cir. 1959).

a. Reg. §1.1002-1(b) provides that §1031 is to be strictly construed and should not be extended beyond its specific provisions and

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underlying purposes. However, the validity of this regulation's interpretation of the scope of §1031 was directly questioned in Starker v. United States, 602 F.2d 1341 (9th Cir. 1979).

C. Statutory requirements and mechanics of §1031

1. General rule. Section 1031(a)(1) provides as follows:

   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.

2. Exceptions. Section 1031(a)(2) provides as follows:

   This subsection shall not apply to any exchange of (A) stock in trade or other property held primarily for sale, (B) stocks, bonds or notes, (C) other securities or evidences of indebtedness or interest, (D) interests in a partnership, (E) certificates of trust or beneficial interests, or (F) choses in action.

3. Essential elements of an exchange qualifying for nonrecognition treatment under §1031.

   a. Property. Only certain types of "property" are eligible for nonrecognition treatment under §1031.

      (1) The properties must be of a "like kind" as discussed in IV.C.3.d., below.

      (2) The properties may not be "... stock in trade or other property held primarily for sale, stocks, bonds, or notes, other securities or evidences of indebtedness or interest, interests in a partnership, certificates of trust or beneficial interests, or choses in action." §1031(a)(2).
(a) "Stock in trade" -- Gulfstream Land & Development Corp. v. Commissioner, 71 T.C. 587 (1979).

(b) "Property held primarily for sale" -- Bernard v. Commissioner, 26 CCH T.C.M. 858 (1967); Griffin v. Commissioner, 49 T.C. 253 (1967); and Klarkowski v. Commissioner, 24 CCH T.C.M. 1827 (1965), aff'd on another issue, 385 F.2d 398 (7th Cir. 1967). Note that $1031(a)(2)(A) excludes "property held primarily for sale" as contrasted with §§1221(1) and 1231(b)(1)(B) which exclude property held "primarily for sale to customers in the ordinary course of a trade or business." See, Black v. Commissioner, 35 T.C. 90 (1960) in which the court stated that the "held for sale" test of §1031 is narrower than that contained in §1221(1), but did not elaborate on the practical effect of the difference.

(c) "Choses in action" -- Gulfstream Land & Development Corp. v. Commissioner, 71 T.C. 587 (1979); Estate of Meyer v. Commissioner, 58 T.C. 311 (1972), aff'd per curiam, 503 F.2d 556 (9th Cir. 1974).

(d) "Certificates of trust or beneficial interest" -- Rutland v. Commissioner, 36 T.C.M. 40 (1977).

(e) "Partnership interest" --

i) Prior to the enactment of $1031(a)(2)(D) by TRA '84, the Service and the Tax Court disagreed as to whether an exchange of partnership interests qualified for nonrecognition treatment under §1031. In Estate of Meyer v. Commissioner, 58 T.C. 311 (1972), aff'd per curiam, 503 F.2d 556 (9th Cir. 1974), nonacq., 1975-1 C.B. 3, the Service argued that partnership interests could not be exchanged tax-free under §1031 because
partnership interests constituted choses in action which were specifically excluded from §1031 by the parenthetical clause of §1031(a) prior to its amendment by T.R.A. '84. The Tax Court rejected this argument and held that the exchange of general partnership interests in different partnerships with similar assets fell within the purview of §1031. However, the Tax Court did find that the exchange of a general partnership interest for a limited partnership interest did not qualify for nonrecognition treatment under §1031 despite the similarity of the underlying assets of the partnerships involved.

ii) Despite its defeat in Estate of Meyer, the Service continued to take the position that exchanges of partnership interests did not fall within §1031, and in Rev. Rul. 78-135, 1978-1 C.B. 256, the Service ruled that an exchange of general partnership interests would not qualify under §1031.

iii) The Tax Court again rejected the Service's position and reaffirmed its own position in Gulfstream Land & Development Corp. v. Commissioner, 71 T.C. 587 (1979). See, also, Long v. Commissioner, 77 T.C. 1045 (1981) (exchange of 50% interest in general partnerships with real estate as the underlying assets qualified under §1031), and Pappas v. Commissioner, 78 T.C. 1078 (1982) (exchange of general partnership interests qualified as a like kind exchange under §1031).

iv) Despite the position taken by the Tax Court, TRA '84 rejected the Tax Court's position and codified the Service's position taken in Rev. Rul. 78-135 that exchanges
of partnership interests are excluded from §1031. §1031(a)(2)(D). However, the House Committee Report makes it clear that §1031(a)(2)(D) excludes only exchanges of interests in different partnerships, so that partnership interests in the same partnership may be exchanged tax-free under §1031. H.R. Rep. No. 98-432, 98th Cong., 2nd Sess. 1231-1234 (1984). Query, whether an exchange of a limited partnership interest for a general partnership interest in the same partnership will qualify under §1031. Though the House Committee Report language arguably covers this situation, Estate of Meyer, supra, would seem to indicate to the contrary.

v) The Service's position on exchanges of a limited partnership interest for a general partnership interest of the same partnership is set forth in Rev. Rul. 84-52, 1984-1 C.B. 157. Rather than treating the transaction as an exchange, Rev. Rul. 84-52 analyzes such a transaction as a distribution of a new partnership interest to the converting partner or partners in exchange for a contribution of their old interests to the partnership under §721. Consequently, under the Service's view, a partner converting his general partnership interest into a limited partnership interest (or vice versa) in the same partnership will recognize no gain or loss on such conversion unless there is a reduction in such partner's share of partnership liabilities under §752 such that the deemed distribution of money to the converting partner under §752(b) exceeds such partner's adjusted
basis in his partnership interest. §731(a)(1).

vi) The Revenue Reconciliation Act of 1990 (the "1990 Act") amended §1031(a)(2) by providing that an interest in a partnership which has properly elected under §761(a) to be excluded from Subchapter K (containing the primary provisions relating to taxation of partnerships and partners) will be treated as an interest in each of the underlying assets of the partnership. See, also, Reg. §1.1031(a)-1(a)(1). This may facilitate the exchange of interests in a real estate partnership. However, the election under §761(a) is only available for real estate partnerships if they are holding real property for investment purposes and not for the conduct of an active trade or business with respect to the real property. For discussion of the opportunities and limitations associated with the use of §761(a) in conjunction with §1031, see, Weller, "1990 Legislation Offers Expanded Possibilities for Exchanges of Real Estate Partnership Interests," The Real Estate Tax Digest, 29-44 (Feb. 1991).

(3) The interest must constitute "property" and not a right to income. Compare Commissioner v. P. G. Lake, 356 U.S. 260 (1958) (mineral rights in the form of carved out oil payment did not constitute "property" for purposes of §1031), with Commissioner v. Crichton, 122 F.2d 181 (5th Cir. 1941), and Rev. Rul. 68-331, 1968-1 C.B. 352 (undivided oil interests and overriding royalties qualified as "property"). Under Reg. §1.1031(a)-1(c), a leasehold interest with 30 years or more to run is considered as "property," but see, Pembroke v. Commissioner, 70 F.2d 850 (D.C. Cir. 1934) and Rev. Rul. 66-209, 1966-2 C.B. 299 which hold that
if a fee owner merely carves out a 30-year leasehold interest from his fee ownership and exchanges it for real property, the leasehold interest will not be treated as property because it will be more in the nature of an assignment of income such as that found in P. G. Lake, supra.

b. Properties must be held for productive use in trade or business or for investment. The regulations under §1031 neither define "held for productive use in trade or business" nor "investment." However, for useful analogies see, §§1231 and 167 regarding trade or business properties and §1221 regarding investment properties.

(1) Property held for productive use in a trade or business may be exchanged for property to be held for investment or vice versa. Reg. §1.1031(a)-(1)(a).

(2) The properties must be held for productive use in a trade or business or held for investment. Thus, if property which would otherwise qualify under §1031 is promptly disposed of in a taxable transaction, it will not be eligible because it is not held for the required purpose. See, Black v. Commissioner, 35 T.C. 90 (1960).

(a) The Service has also taken the position that if property received in an exchange which would otherwise qualify under §1031 is promptly disposed of in a non-taxable transaction, such property will not be eligible for §1031 treatment because it was not "held" for the required purposes. See, e.g., Rev. Rul. 75-292, 1975-2 C.B. 333 (property received in a purported §1031 exchange immediately transferred to a controlled corporation under §351 ineligible for §1031 nonrecognition treatment).

(b) The Tax Court in Wagenson v. Commissioner, 75 T.C. 653 (1980) held that an exchange followed by a gift
of the replacement property within nine months of the exchange did not violate the "holding" requirement. However, in Click v. Commissioner, 78 T.C. 223 (1982), the Tax Court struck down a purported §1031 exchange because it found that the taxpayer had intended as of the time of the exchange to give away the replacement property (and did so within 7 months thereafter).

(c) In Magneson v. Commissioner, 81 T.C. 767 (1983), aff'd 753 F.2d 1490 (9th Cir. 1985), the Tax Court found that a prearranged transfer of real property received in a like kind exchange to a partnership in return for an interest in the partnership satisfied the holding requirement of §1031(a). The court's holding was limited to those situations in which a taxpayer exchanges property for like kind property with the intent to contribute it to a partnership for a general partnership interest.

i) The court distinguished Rev. Rul. 75-292, supra, on the following grounds: (1) a corporation is an entity separate and apart from its shareholders while a partnership is an association of the partners making up the partnership and (2) a like kind exchange in conjunction with an §351 transfer "viewed as a whole" results in the exchange of property for stock, a transaction expressly excluded from §1031.

ii) Continued reliance on the Magneson decision, however, is uncertain in light of the enactment of §1031(a)(2)(D) by TRA '84. Section 1031(a)(2)(D) expressly excludes a partnership interest as like kind property.

(d) See, also, Bolker v. Commissioner, 81 T.C. 782 (1983), aff'd, 85-1 U.S.T.C. ¶9400 (9th Cir. 1985), which held
that an exchange of real property received in an §333 tax-free liquidation for like kind property qualified under §1031(a). The court found that whether an exchange of like kind property is preceded by, or succeeded by, a tax-free acquisition or transfer of property should not affect nonrecognition treatment under §1031(a).

i) However, the Ninth Circuit emphasized that the taxpayer had decided to exchange the property only after the adoption of the plan of liquidation, thus implying that a different result might have followed if the intent to exchange predated the adoption of the liquidation plan.

ii) For the Service's view (contrary to Bolker) on similar facts, see, Rev. Rul. 77-337, 1977-2 C.B. 305.

(e) Mason v. Commissioner, 55 T.C.M. 1134 (1988) sanctioned an exchange of real property which was received by the taxpayer as a distribution from a partnership in which the taxpayer was a partner. The opinion contains very little analysis of the applicable issues and, as a memorandum decision, has little precedential value.

(f) See, also, Maloney v. Commissioner, 93 T.C. 89 (1989), in which the Tax Court upheld the application of §1031 to an exchange of real properties by a corporation on December 28, 1978, which was followed four days later by the transfer of the replacement property to the corporation's shareholders pursuant to an §333 liquidation. The Tax Court emphasized the continuity of investment by the corporation's shareholders and ignored the fact that the corporation clearly intended to liquidate and distribute the replacement property it received in
the exchange even as the exchange was being negotiated and consummated. But see, Chase v. Commissioner, 92 T.C. 874 (1989), which involved a case in which the taxpayer did everything wrong resulting in a win for the Service.

(g) Proposals were advanced by both Treasury and Chairman Rostenkowski of the House Ways and Means Committee that would have effectively repealed Bolker, Magneson, and Maloney in connection with the Revenue Reconciliation Act of 1989 by requiring that the taxpayer hold both the property exchanged and the replacement property for at least one year. However, these proposals were dropped prior to enactment of the final Bill.

c. Exchange. Section 1031(a) specifically limits its application to exchanges (as opposed to sales or other forms of disposition) of property. While the presence or absence of an exchange would normally be self-evident, the issue may become obscured in the case of multi-party exchanges discussed in IV.D. and E., below. Moreover, even though the parties may have clearly contemplated an exchange, if they attempt to short cut the formalities of an exchange, especially in the case of three-cornered exchanges (see, discussion in IV.D., below), the result may be a sale rather than an exchange. Bezdjian v. Commissioner, 845 F.2d 217 (9th Cir. 1988); Carlton v. United States, 385 F.2d 238 (5th Cir. 1967); Swaim v. United States, 81-2 U.S.T.C. ¶9575 (5th Cir. 1981); Rogers v. Commissioner, 44 T.C. 126 (1965), aff'd per curiam, 377 F.2d 534 (9th Cir. 1967).

d. Like kind. The regulations adopt a liberal construction of "like kind" for purposes of applying the nonrecognition rules:

... The words 'like kind' have reference to the nature or character of the property and not to its grade or quality. ... The fact that any real
estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class. Reg. §1.1031(a)-1(b).

In the case of real estate, as noted in the above quoted portion of the regulations, improved real estate may be exchanged for unimproved real estate, and city real estate may be exchanged for a ranch or farm. Reg. §1.1031(a)-1(c). Similarly, a leasehold interest with 30 years or more to run may, if it represents the taxpayer's entire interest in the property (see, discussion under "Property" in IV.C.3.a., supra) be exchanged for a fee interest in real property. Reg. §1.1031(a)-1(c). An undivided interest as a tenant in common may also be exchanged for a fee title. Rev. Rul. 73-476, 1973-2 C.B. 300.

(1) The Revenue Reconciliation Act of 1989 added new §1031(h) which provides the U.S. real property will not be deemed to be "like kind" with real property located outside of the U.S.

4. Boot. The general rule for nonrecognition treatment set forth in §1031(a) requires that qualifying property must be exchanged solely for other qualifying property. However, §1031(b) provides that if an exchange would otherwise be eligible for tax free exchange treatment under §1031(a) but for the presence of some nonqualifying property ("boot"), any gain realized in the transaction (i.e., economic gain) will be recognized for tax purposes to the extent of the sum of money and fair market value of the nonqualifying property received. If the exchange results in a realized loss (i.e., economic loss) and boot is received, §1031(c) provides that the loss will not be recognized.

a. Example of operation of "boot" rule. TP, who owns TP Land with a fair market value of $100,000 and a tax basis of $50,000, enters into an exchange with X who owns X Land with a fair market value of $80,000. X transfers X Land to TP plus $20,000 in exchange for TP Land. TP's realized gain will be computed as follows:

- 45 -
$80,000  Fair market value of X Land received
+20,000  Cash received
$100,000  Total consideration
-50,000  Basis in TP Land transferred
$ 50,000  Realized gain

Under §1031(b), $20,000 of TP's total realized gain of $50,000 must be recognized (i.e., reported for tax purposes) due to the receipt of $20,000 of boot (cash) by TP.

b. Three forms of boot. "Boot" can be received in three different forms.

(1) Cash

(2) Nonqualifying property

   (a) Property which is not "like kind." §1031(a)(1).

   (b) Property which is not held for productive use in a trade or business or for investment. §1031(a)(1).

   (c) Stock in trade or other property held primarily for sale, stocks, bonds, or notes, other securities or evidences of indebtedness or interest, interests in a partnership, certificates of trust or beneficial interests, or choses in action. §1031(a)(2).

(3) Relief from liabilities either through assumption of such liabilities by the other party to the exchange or by a conveyance of property to the other party subject to an existing liability and mortgage. Reg. §1.1031(b)-1(c).

c. Netting of boot. In many exchanges a taxpayer will both give and receive boot. In such instances the regulations tolerate some "netting" of boot.

(1) Under Reg. §1.1031(b)-1(c), liabilities of the taxpayer encumbering his property which are either assumed or taken subject to by the other party to the exchange may be offset, or "netted," against liabilities encumbering the other party's property which are either assumed or taken subject
to by the taxpayer in the exchange. Although not specifically stated in the statute, Reg. §1.1031(d)-2, Ex.2, makes it clear that if the taxpayer assumes or takes property subject to existing debt such debt will reduce the amount of gain realized.

(2) Liabilities of the taxpayer encumbering his property which are assumed or taken subject to by the other party to the exchange may also be offset by cash given by the taxpayer to such other party. Reg. §1.1031(d)-2, Exs. 1 and 2; Barker v. Commissioner, 74 T.C. 555 (1980). Query, may nonqualifying property given by the taxpayer also be netted against mortgage indebtedness of the taxpayer which is assumed or taken subject to by the other party to the exchange? Dicta in the Tax Court's Barker decision suggests that it may. 74 T.C. 555 (1980). See, also, Ltr. Rul. 8003004 (Sept. 19, 1979). The issuance of a promissory note by the taxpayer as partial consideration for the replacement property will be treated as boot. Rev. Rul. 79-44, 1979-1 C.B. 265. Query also whether such a note may be netted against the taxpayer's liabilities which are assumed or taken subject to in the exchange.

(3) A taxpayer who receives cash or nonqualifying property to compensate for a difference in net values in the properties (fair market value less mortgage) cannot offset such boot by boot given in the form of assumption of debt by the taxpayer encumbering the property received (or taking subject to such debt). Reg. §1.1031(d)-2, Ex. 2; Barker v. Commissioner, 180 F.2d 758 (8th Cir. 1950). This rule is apparently predicated upon the assumption that the taxpayer receiving the cash or other nonqualifying property is free to use it for whatever purposes he desires and is not necessarily required to apply it in reduction of the "excess" mortgage indebtedness assumed.

(a) Query, in an effort to avoid receiving cash, may be taxpayer and the other party to the exchange agree that the
taxpayer will refinance his mortgage to the level necessary to eliminate the necessity of receiving cash from the other party? If this is done in anticipation of the exchange, the additional debt so created may nevertheless be treated as a cash payment. Cf. Shubin v. Commissioner, 67 F.2d 199 (3rd Cir. 1934), cert. denied, 291 U.S. 664 (1933); Rev. Rul. 73-555, 1973-2 C.B. 159 involving the impact of mortgaging property immediately prior to sale on "payments received in the year of sale" under §453 (installment sales provisions); and Ltr. Rul. 8434015 (pre-exchange borrowing treated as cash received in exchange). But see, 124 Front Street, Inc. v. Commissioner, 65 T.C. 6 (1975), acq., 1976-2 C.B. 2, nonacq., 1976-2 C.B. 3; and Garcia v. Commissioner, 80 T.C. 491 (1983) (increase of mortgage on property to be received in like kind exchange as precondition to exchange in order to avoid recognition of boot gain due to relief of liability on property given up respected as legitimate debt). Cf. also Temp. Reg. §15A.453-1(b)(2)(iv), in defining "qualified indebtedness" for installment reporting purposes, which would treat any related pre-sale borrowing as a cash payment in connection with the sale.

(b) Query, also, whether the other party to the exchange may reduce the level of his indebtedness to eliminate the payment of cash? See, Garcia, supra.

(c) A legitimate method of minimizing or eliminating the receipt of boot is to have the other party to the exchange construct desired improvements on the property to be received by the taxpayer in the exchange with the monies that would otherwise have been paid as boot. See, Coastal Terminals, Inc. v. United States, 320 F.2d 333 (4th Cir. 1963); and J.H. Baird Publishing Co. v. Commissioner, 39 T.C. 608 (1962), acq., 1963-2 C.B. 4.
(4) Example of effects of boot netting rule (adapted from Reg. §1.1031(d)-2, Ex. 2). TP owns the TP apartment house. On June 15, 1992, the TP apartment house has an adjusted tax basis in TP's hands of $100,000, a fair market value of $200,000 and is subject to a mortgage of $80,000. Thus, the net fair market value of the TP apartment house on June 15, 1992, is as follows:

\[
\begin{align*}
$220,000 & \text{ Fair market value} \\
-40,000 & \text{ Mortgage} \\
$140,000 & \text{ Net fair market value}
\end{align*}
\]

X owns the X apartment house which on June 15, 1992, has an adjusted tax basis in X's hands of $175,000, a fair market value of $250,000 and is subject to a mortgage of $150,000. Thus, the net fair market value of the X apartment house on June 15, 1992, is as follows:

\[
\begin{align*}
$250,000 & \text{ Fair market value} \\
-150,000 & \text{ Mortgage} \\
$100,000 & \text{ Net fair market value}
\end{align*}
\]

On June 15, 1992, TP and X exchange the TP apartment house for the X apartment house. Since the TP apartment house has a net fair market value $40,000 greater than the X apartment house, X pays TP $40,000 in cash at closing. Each apartment house is transferred subject to the existing indebtedness which is assumed by the parties. The tax treatment of TP and X is as follows:

(a) Tax treatment of TP:

\[
\begin{align*}
$250,000 & \text{ Fair market value of X apartment house received} \\
+ 80,000 & \text{ Mortgage on TP apartment house assumed by X} \\
+ 40,000 & \text{ Cash} \\
$370,000 & \text{ Total consideration received} \\
-100,000 & \text{ Adjusted tax basis in TP apartment house} \\
-150,000 & \text{ Mortgage on X apartment house assumed by TP} \\
$120,000 & \text{ Net realized gain}
\end{align*}
\]
For purposes of §1031(b), the amount of net boot received by TP is $40,000 and, thus, $40,000 of TP's realized gain must be recognized for tax purposes. This figure was computed by netting $80,000 of the $150,000 mortgage assumed by TP against the $80,000 mortgage encumbering the TP apartment house assumed by X. However, although TP assumed $70,000 more indebtedness of X ($150,000 minus $80,000), this excess may not be offset against the $40,000 of cash boot received by TP.

(b) Tax treatment of X:

$220,000 Fair market value of TP apartment house received  
+150,000 Mortgage on X apartment house assumed by TP  
$370,000 Total consideration received  
-175,000 Adjusted tax basis in X apartment house  
- 80,000 Mortgage on TP apartment house assumed by X  
- 40,000 Cash paid by X  
$ 75,000 Net realized gain

For purposes of §1031(b), the amount of net boot received by X is $30,000 with the result that $30,000 of X's realized gain must be recognized for tax purposes. X received boot in the amount of $150,000 by virtue of TP's assumption of the mortgage on the X apartment house, but X was entitled to offset this by both the $80,000 mortgage assumed by X on the TP apartment house and the $40,000 in cash paid by X to TP.

d. Installment reporting of recognized gains.
Prior to the Installment Sales Act, it was difficult to qualify for installment reporting of the taxpayer's gain resulting from the receipt of boot in the form of an installment note because the receipt of qualifying property was treated as a "payment in the year of sale" for purposes of the 30% test under §453(b)(2)(A) prior to its amendment by the Installment Sales Act. Mitchell v. Commissioner, 42 T.C. 953 (1964), acq., 1965-2...
C.B. 6. However, under current §453(f)(6)(C), "payments" do not include qualifying properties received in an §1031 exchange and installment obligations are not taxed in the year of receipt. Thus, if a taxpayer wishes to spread his recognized gain attributable to boot received in an §1031 exchange, he may negotiate for receipt of an installment note from the other party in lieu of cash or other nonqualifying property. In addition, the total contract price will be reduced for the amount of nonrecognition property received in the exchange under §453(f)(6)(A), and the gross profit is reduced for any realized gain that will not be recognized due to §1031 under §453(f)(6)(B). For purposes of reporting the taxpayer's taxable gain upon receipt of installment payments in an §1031 transaction, the taxpayer's basis will first be allocated to qualifying property received to the extent of its fair market value with the excess (if any) being applied against the installment payments. See, Prop. Reg. §1.453-1(f)(1)(iii). Thus, the taxpayer will not have any basis in the installment note unless the basis in his relinquished property is greater than the value of his replacement property.

5. Basis and holding periods. Section 1031 is a deferral provision. Like most deferral provisions in the Code, it exacts a price for nonrecognition in the form of a reduction in basis in qualifying property received in an §1031 exchange.

a. General rule. Section 1031(d) provides that the basis of qualifying (like kind) property received in an §1031 exchange is equal to the basis of the property transferred, reduced by any cash received and any loss recognized (which would be attributable to exchange of "boot properties"), and increased by any gain recognized.

(1) The basis of property received by a taxpayer in an §1031 exchange may also be increased by the amount of any cash paid by the taxpayer. Reg. §1.1031(d)-2, Ex. 2. Broker's commissions paid by the taxpayer will also increase the taxpayer's basis in the newly acquired property. Rev. Rul. 72-456, 1972-2 C.B. 468.
(2) If two or more qualifying properties are received in the exchange, the taxpayer's basis must be allocated between such properties in proportion to their relative fair market values. Rev. Rul. 68-36, 1968-1 C.B. 357; Mitchell v. Commissioner, 42 T.C. 953 (1964), acq., 1965-2 C.B. 6.

(3) If both qualifying property and boot are received in the exchange, basis will first be allocated to boot to the extent of its full fair market value. For example, assume TP has TP property with a fair market value of $100,000 and a tax basis of $50,000 and he exchanges it for X property (which is like kind property) with a fair market value of $80,000 plus securities with a fair market value of $20,000. $20,000 of TP's $50,000 realized gain must be recognized due to the presence of the $20,000 of boot (securities). TP's basis in the X property would be computed as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis in TP property</td>
<td>$50,000</td>
</tr>
<tr>
<td>Gain recognized</td>
<td>+20,000</td>
</tr>
<tr>
<td>Total basis of qualifying and nonqualifying property</td>
<td>$70,000</td>
</tr>
<tr>
<td>Basis allocable to securities (fair market value of securities)</td>
<td>-20,000</td>
</tr>
<tr>
<td>Basis of X property</td>
<td>$50,000</td>
</tr>
</tbody>
</table>

(4) Any liabilities encumbering the taxpayer's property which are assumed or taken subject to by the other party to the exchange will be treated the same as cash received for purposes of the basis computation rules. S1031(d) (last sentence).

(a) If both of the properties exchanged are encumbered by mortgages, and assuming that no other boot is given or received other than in the form of mortgages, the basis of the acquired property would be computed as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis of property surrendered</td>
<td></td>
</tr>
<tr>
<td>Mortgage on property surrendered</td>
<td></td>
</tr>
<tr>
<td>Mortgage on property received</td>
<td></td>
</tr>
<tr>
<td>Gain recognized</td>
<td></td>
</tr>
<tr>
<td>Net adjusted basis of newly acquired property</td>
<td></td>
</tr>
</tbody>
</table>
The basis provisions of §1031(d) provide the mechanism through which gains which are not initially recognized under §1031(a) will eventually be taxed. In essence, the tax basis of the newly acquired property is reduced under §1031(d) by the amount of the unrecognized gain. Thus, when the newly acquired property is later disposed of in a taxable transaction the "latent gain" will then be recognized. In the interim, if the newly acquired property is depreciable property the basis for depreciation is correspondingly less, thus reducing the amount of depreciation deductions the taxpayer may claim. Of course, if the taxpayer should die prior to disposition of the newly acquired property, his estate would be entitled to a stepped up basis in the property under §1014 and the latent gain would then be eliminated.

Temp. Reg. §§1.1031(d)-1T and 1.1060-1T(g) were issued in 1988 governing the relationship of §§1031 and 1060. If a transaction that would otherwise be an "applicable asset acquisition" under §1060 is in part a §1031 exchange, the new temporary regulations provide that §1060 applies not only to the qualifying property but also to the boot received in exchange for like kind property.

b. Holding period. Tacking of holding periods is authorized under §1223(1) with respect to qualifying properties if such properties are either capital assets, as defined in §1221, or properties described in §1231.

6. Relationship to depreciation recapture provisions.

a. Section 1245. Section 1245(b)(4) carves out an exception to the general recognition forcing rule of §1245(a) and provides that if property is disposed of and gain is not recognized in whole or in part under §1031, then the amount of gain to be recognized under §1245(a)(1) shall not exceed the sum of the following:

(1) the amount of gain recognized on the disposition (determined without regard to §1245 -- i.e., due to the presence of boot), plus
(2) the fair market value of non-section 1245 property that is not taken into account under (1) above.

If only like kind ("qualifying") properties are exchanged, then no gain will be recognized under §1245 except to the extent that the fair market value of the §1245 property disposed of exceeds the fair market value of the §1245 property received. See, §1245(b)(4)(B). On the other hand, if gain is recognized on the §1031 exchange because of the presence of boot, then the potential §1245 recapture income will be recognized subject to the limitations set forth in (1) and (2) above.

b. Section 1250. Section 1250(d)(4) provides that if properties are exchanged and gain is not recognized in whole or in part under §1031, then the amount of §1250 gain that is to be recognized will be limited to the greater of the following:

(1) The amount of gain recognized under §1031 (i.e., due to the presence of boot), or

(2) The excess of the amount of realized §1250 gain over the fair market value of the §1250 property received in the exchange.

It should be noted that, under §1250(e) there will be no tacking or holding periods in an §1031 exchange of §1250 properties for the purposes of determining the "applicable percentage" under the recapture phase-out rules.

7. Different treatment of parties to exchange. It is permissible to have one party to an exchange qualify for nonrecognition treatment under §1031 while the other party does not. See, e.g., Rev. Rul. 77-297, 1977-2 C.B. 304.

8. Exchanges between related parties. The Revenue Reconciliation Act of 1989 added new §§1031(f) and (g) limiting the application of §1031 nonrecognition treatment with respect to exchanges between related parties.

a. The impetus for the change was the concern of Congress that §1031 was being employed to avoid the impact of TRA '86's repeal of General...
Utilities. For example, assume corporation X owns 100% of the stock of the corporations Y and Z. Corporation Y owns property 1 with a fair market value of $1,000,000 and a tax basis of $100,000. Corporation Z owns property 2 with a fair market value and basis of $1,000,000. Corporation Y desires to sell property 1 but does not want to incur the tax on $900,000 of gain inherent in the property. In order to avoid taxation on this gain, corporation Y and corporation Z exchanges property 1 for property 2. Sometime after the exchange, corporation Z, which now owns property 1 with a new $1,000,000 substituted basis (see, §1031(d)) sells property 1 and recognizes no gain on the transaction.

b. In order to preclude the result described in 8.a., above, §1031(f) now provides that if a taxpayer obtains nonrecognition treatment under §1031 upon an exchange of property with a "related person," nonrecognition treatment will be lost if either the taxpayer or the related party dispose of either property within a specified period of time.

(1) Any gain or loss not recognized by reason of §1031(f) will, subject to the loss nonrecognition rules of §267 be recognized as of the date of the subsequent disposition. §1031(f)(1)(C).

c. The purgatory period of §1031(f) commences with the date of the first transfer and runs through the date prior to the second anniversary of the last transfer that was a part of the original exchange. §1031(f)(1)(A) and (C) (read together).

(1) The two (plus) year period will be suspended and held open under §1031(g) for any period of time in which any of the exchange properties for which nonrecognition treatment was afforded under §1031 are subject to a "put," a "call," a short sale or any transaction with similar effect (providing that such put, call, etc. arose prior to the expiration of the two-year period).
d. In defining "related parties," §1031(f)(3) adopts the definitional rules contained in §267(b) and §707(b)(1).

e. Section 1031(f)(2) provides exceptions to the forced recognition rules of §1031(f)(1) in the following instances:

(1) After the earlier of the death of the taxpayer or the related person; or

(2) A disposition resulting from a compulsory or involuntary conversion (provided that the original exchange was finalized before the threat or imminence of such conversion); or

(3) In other circumstances if it is established to the satisfaction of the Service that neither the original exchange nor the subsequent disposition had as one of its principal purposes the avoidance of federal income tax.

f. New §§1031(f) and (g) apply generally to transfers occurring after July 10, 1989 (subject to the normal binding contract rules).

D. Multi-party exchanges

1. Factual setting. The original draftsman of §1031 and its predecessor provisions undoubtedly envisioned its application in "barter" transactions in which each party owned property that the other party desired and they would simply exchange these properties. In reality, however, this rarely occurs. In most instances, if X wishes to acquire the taxpayer's property he probably will not own property that the taxpayer would like to acquire in an exchange and, further, X probably would have little interest in participating in a land exchange but for the fact that this may be the only method by which he can acquire the taxpayer's property. In such a situation X may agree to accommodate the taxpayer by acquiring property selected by the taxpayer for the sole purpose of swapping it for the taxpayer's property. Thus, another party, the owner ("C") of the property that the taxpayer would like to acquire in the exchange is interjected into the picture. This scenario and a number of variations thereof is referred to as a "multi-party exchange." Most multi-party exchanges fall into
one of two molds -- the "three-cornered exchange" and the "four-party exchange."

a. Three-cornered exchange. A typical three-cornered exchange derives its name from the fact that it involves three participants -- the taxpayer who owns TP property; X who wants to acquire the TP property; and C, who owns the C property that TP would like to acquire. The transaction is usually structured in one of two ways.

(1) In the most common pattern, X will acquire the C property from C and immediately thereafter exchange it with TP for the TP property. The net result of these transactions is that TP acquires the C property in an §1031 exchange; C sells his property in a taxable transaction; and X ends up with the TP property and is "out of pocket" the cost of the C property.

(2) Another popular variation of the three-cornered exchange involves TP exchanging TP property with C for the C property. C, having just acquired the TP property in the exchange, immediately thereafter sells the TP property to X. The net result of this transaction is the same as (1), above.

b. Four-party exchange. The four-party exchange is similar to the three-cornered exchange except that an "accommodation party" (i.e., a "fourth party" in addition to the taxpayer, X and C) assumes a role in the transaction. In many instances the intended purchaser (X) of the taxpayer's property is unwilling or unable to acquire the property that the taxpayer wishes to acquire in the exchange. In order to effectuate the transfer the accommodation party (usually a title company, a bank or, in some instances, an attorney for one of the parties) will either acquire the desired exchange property, exchange it for the taxpayer's property, and then sell it to X or, alternatively, acquire the exchange property and resell it to X who then exchanges it for the taxpayer's property.
2. Essential elements of multi-party exchanges.

Initially the Service considered multi-party exchanges as being outside the realm of §1031 and took the position that they were tantamount to a taxable sale followed by a reinvestment of the proceeds. Fortunately for taxpayers, the early decisions in this area adopted a liberal construction of §1031 as it applied to multi-party exchange situations and established a pro-taxpayer trend that, with some judicial deviations, has been liberalized to an even greater extent in recent years. See, e.g., Mercantile Trust Co. of Baltimore v. Commissioner, 32 B.T.A. 82 (1935), acq., XIV-1 C.B. 13; J. H. Baird Publishing Co. v. Commissioner, 39 T.C. 608 (1962), acq., 1963-2 C.B. 4; Alderson v. Commissioner, 317 F.2d 790 (9th Cir. 1963); and Coastal Terminals, Inc. v. United States, 320 F.2d 333 (4th Cir. 1963) (which represent the early line of cases applying an expansive application of §1031 to multi-party exchanges); and Biggs v. Commissioner, 632 F.2d 1171 (5th Cir. 1981); Starker v. United States, 602 F.2d 1341 (9th Cir. 1979); Barker v. Commissioner, 74 T.C. 555 (1980); Brauer v. Commissioner, 74 T.C. 1134 (1980); Hayden v. United States, 82-2 U.S.T.C. ¶9604 (D.Wyo. 1981); and Garcia v. Commissioner, 80 T.C. 491 (1983), acq., 1984-1 C.B. 1 (more recent and, if anything, more liberal (pro-taxpayer) decisions than their predecessors).

(1) Realistically, there is a fine line dividing the characterization of many, if not most, multi-party exchanges as §1031 exchanges rather than as taxable sales and reinvestments. The courts have utilized several familiar tax doctrines -- "substance over form," "step transaction" and "constructive receipt" -- to analyze the factual basis of multi-party exchanges to support their findings of exchange treatment. For a discussion of the application of these three doctrines in the area of multi-party exchanges, see, Guerin, "A Proposed Test for Evaluating Multi-Party Like Kind Exchanges," 35 Tax L. Rev. 547, 555-586 (1980). However, "one cannot escape the impression that if it were not
for the fact that the early decisions in three-party exchange cases applied §1031 in a liberal manner, and later decisions 'followed the leader' on the basis of stare decisis, there might have been a trend against the taxpayer's position." Dean, "Three-Party Exchanges of Real Estate," 17 Tulane Tax Inst., 131, 137.


(3) Despite the favorable trend of the cases, several decisions stand out as a clear warning to taxpayers and their counsel that the formalities of an exchange must be adhered to: Carlton v. Commissioner, 385 F.2d 238 (5th Cir. 1967); Rogers v. Commissioner, 44 T.C. 126 (1965), aff'd per curiam, 377 F.2d 534 (9th Cir. 1967); Bezdiian v. Commissioner, 845 F.2d 217 (9th Cir. 1988); Halpern v. United States, 286 F.Supp. 255 (N.D. Ga. 1968); Swaim v. United States, 79-2 U.S.T.C. ¶9462 (N.D. Tex. 1979), aff'd, 81-2 U.S.T.C. ¶9575 (5th Cir. 1981); Meadows v. Commissioner, 42 CCH T.C.M. 611 (1981); Allen v. Commissioner, 49 CCH T.C.M. 1352 (1985); and Lee v. Commissioner, 51 CCH T.C.M. 1438 (1986). In a Tax Court decision holding in favor of the taxpayer, the Tax Court made the following observation:

The "exchange" requirement poses an analytical problem because it runs headlong into the familiar tax law maxim that the substance of a transaction controls over form. In a sense, the substance of a transaction in which the taxpayer sells property and immediately reinvests the proceeds in like kind property is not much different from the substance of a transaction in which two parcels are exchanged without cash . . . yet, if the exchange requirement is to have any significance at all, the perhaps formalistic difference between the two
types of transactions must at least on occasion, engender different results. *(Barker v. Commissioner, 74 T.C. 555 (1980))*

b. Essential elements. Despite the liberal trend of the cases in this area, the Courts have set down certain prerequisites for recognition of multi-party exchanges as valid §1031 exchanges.

(1) There must be an intent to effect an exchange. In most multi-party exchanges, the purchaser ("X") reserves the option to pay cash for the taxpayer's property which, if exercised, would preclude the applicability of §1031. If the contract is not properly drafted, the true intent of the parties (i.e., whether to effect a sale or exchange) is often difficult to determine. The Fourth Circuit Court of Appeals in Coastal Terminals, Inc. v. United States, made the following observation in this regard:

> Whether the transaction constituted a sale or an exchange for income tax purposes depends on the intent of the parties and this intent is to be ascertained from all relevant facts and circumstances, and of necessity the case is largely dependent upon circumstantial evidence. *(320 F.2d 333, 337 (emphasis added))*

For other cases in which the intent factor was stressed by the Courts, see, Alderson v. Commissioner, 317 F.2d 790 (9th Cir. 1963); 124 Front Street, Inc. v. Commissioner, 65 T.C. 6 (1975), acq., 1976-2 C.B. 2, nonacq., 1976-2 C.B. 3; and Barker v. Commissioner, 74 T.C. 555 (1980). However, the intent of the parties to effect an exchange will not be sufficient in and of itself to characterize an otherwise defective transaction as an §1031 exchange. Carlton v. Commissioner, 385 F.2d 238 (5th Cir. 1967); and Rogers v. Commissioner, 44 T.C. 126 (1965), aff'd per curiam, 377 F.2d 534 (9th Cir. 1967).

(2) An "exchange" must actually be consummated. Carlton v. Commissioner, supra; Bezdjian v.
(3) The "other parties" to the transaction must not be the taxpayer's agents. This is a crucial determination, especially in four-party exchanges, and represents one of the Service's principal points of attack in some recent cases. However, the Courts have thus far been very tolerant in this area, even to the point of ignoring strong circumstantial evidence of the existence of an agency relationship between the taxpayer and the accommodation party, so long as there is no express agency agreement between the taxpayer and the accommodation party. See, Alderson v. Commissioner, 317 F.2d 790 (9th Cir. 1963); Mercantile Trust Co. of Baltimore v. Commissioner, 32 B.T.A. 82 (1935), acq., XIV-1 C.B. 13; J. H. Baird Publishing Co. v. Commissioner, 39 T.C. 608 (1962), acq., 1963-2 C.B. 4; Coupe v. Commissioner, supra; and Biggs v. Commissioner, 632 F.2d 1171 (5th Cir. 1981). However, the IRS apparently takes the position that an agency relationship will depend upon who has assumed the risk in the acquisition of the exchange property. See, Rev. Rul. 77-297, 1977-2 C.B. 304.


(1) However, a taxpayer's transfer of property in exchange for another party's construction of improvements on other property of the taxpayer will not qualify under §1031. Bloomington Coca-Cola Bottling Co. v. Commissioner, 189 F.2d 14 (7th Cir. 1951).

(2) Query, the result if the taxpayer sells property No. 1 (which has a high basis in his hands) to the other party (X) and simultaneously enters into a contract with X to construct improvements on property No. 1 and reconvey it to the taxpayer in exchange for other property owned by the taxpayer (which has a low basis in the taxpayer's hands)? Compare Ltr. Rul. 7823035 and 8217106 (which hold for the taxpayer) with Smith v. Commissioner, 537 F.2d 972 (8th Cir. 1976) (which reached an opposite conclusion).

c. Taxpayer may locate suitable property to be received in exchange and may negotiate for acquisition of such property. Coastal Terminals, Inc. v. United States, supra; Alderson v. Commissioner, 317 F.2d 790 (9th Cir. 1963); Coupe v. Commissioner, 52 T.C. 394 (1969), acq., 1970-2 C.B. VIX; Rutland v. Commissioner, 36 CCH T.C.M. 40 (1977); and Garcia v. Commissioner, 80 T.C. 491 (1983).

d. Taxpayer may loan money to other party to enable him to acquire and/or improve property to be received by taxpayer in the exchange.

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Other party to exchange need not actually take title to exchange property. *W.D. Haden Co. v. Commissioner*, 165 F.2d 588 (5th Cir. 1948); *Rutland v. Commissioner*, 36 CCH T.C.M. 40 (1977); *Biggs v. Commissioner*, 632 F.2d 1171 (5th Cir. 1981); and *Brauer v. Commissioner*, 74 T.C. 1134 (1980).

f. Taxpayer may reimburse other party for his closing costs incurred to acquire exchange property. *Biggs v. Commissioner*, 632 F.2d 1171 (5th Cir. 1981); *Rutland*, supra.

g. A general caveat with respect to use of too many, or all, of the above referenced actions was sounded by the Tax Court in *Barker*:

Notwithstanding those deviations from the standard multiple-party exchanges which have received judicial approval, at some point the confluence of some sufficient number of deviations will bring about a taxable result. Whether the cause be economic and business realities or poor tax planning, prior cases make clear that taxpayers who stray too far run the risk of having their transactions characterized as a sale and reinvestment.

E. Deferred exchanges.

1. Description. A great deal of interest, both on the part of taxpayers and the Service, has focused on developments in the area of deferred multi-party exchanges. The fact pattern is as follows: The taxpayer owns property which he desires to exchange (rather than sell) for suitable like kind property in an §1031 exchange. X desires to acquire the taxpayer's property and is willing to cooperate in effecting a tax free exchange. However, the taxpayer may not have located suitable property for exchange or, if located, the exchange property may not be available for an immediate exchange. The taxpayer and X agree that the taxpayer will transfer his property to X now in exchange for X's promise to acquire suitable exchange property and
convey it to the taxpayer within some given time frame.

2. Issues in deferred exchanges and case history. Several issues arise within the context of a deferred exchange.

a. Has there been an "exchange"? If "exchange" is given its customary meaning, it would presumably encompass only a simultaneous, reciprocal transfer of properties between the two parties. However, case law has not adopted such a literal interpretation of "exchange" for the purposes of §1031. Redwing Carriers, Inc. v. Tomlinson, 399 F.2d 652 (5th Cir. 1968); Starker v. United States, 602 F. 2d 1341 (9th Cir. 1979); Starker v. United States, 432 F. Supp. 864 (D.C. Ore. 1977); J. H. Baird Publishing Co. v. Commissioner, 39 T.C. 608 (1962), acq., 1963-2 C.B. 4; and Rutherford v. Commissioner, 37 CCH T.C.M. 1851 (1978).

b. Are the initial transfer of the taxpayer's property to X and the subsequent transfer of the exchange property by X to the taxpayer "steps in a single, integrated transaction"? The application of the step transaction doctrine in the area of §1031 exchanges has been summarized as follows:

When a series of related steps is part of a preconceived plan, they should be regarded as one transaction in determining whether taxable gain or loss is recognized. On the other hand, where there is no interdependency between the steps, each must be treated separately in determining tax consequences. In order to determine whether the doctrine should apply, the test is whether the steps were so mutually, interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series. (Guerin, "A Proposed Test for Evaluating Multi-Party Like Kind Exchanges," 35 Tax L. Rev. 547, 577 (1980), citing American Bantam Car Co., 11 T.C. 397, 405 (1948), aff'd per curiam, 177 F.2d 513 (3rd Cir. 1949), cert. denied, 339 U.S. 920 (1950))
Other authors have postulated that the proper application of the step transaction doctrine to deferred multi-party exchanges should be as follows:

... the integrated transaction doctrine should be interpreted so that a Taxpayer should not be denied §1031 treatment when he parts with title to the Original Property in exchange for something other than the immediate receipt of title to the Exchange Property, so long as the acquisition of the 'something' is a step in the acquisition of the Exchange Property, and does not give the Taxpayer the option to terminate the transaction and be left with the cash value of the Original Property. (Levun and Gehring, "Like Kind Exchanges: Is Simultaneity a Requirement?" 34 Tax Lawyer 119, 131 (1980))

c. Is X's promise to convey exchange property to the taxpayer at a future date a "chose in action" or, alternatively, a "cash equivalent" which would not qualify as like kind property? At least two courts have held that it is not (Starker v. United States, 602 F.2d 1341 (9th Cir. 1979); and Coupe v. Commissioner, 52 T.C. 394, 409 (1969), acq., 1970-2 C.B. VIX), and the enactment of §1031(a)(3) by TRA '84 leaves no doubt that such promises will not be viewed as choses in action or cash equivalents.

3. IRS position on deferred exchanges prior to TRA '84. The Service initially approved a deferred exchange in Ltr. Rul. 7938087 on June 22, 1979. However, on November 8, 1979, the Service announced that it was reconsidering its position on deferred exchanges in Ltr. Rul. 8005049. Finally, on August 25, 1980, the IRS revoked Ltr. Rul. 7938087 stating that "... it has been concluded the non-simultaneous nature of the exchange in this case does not satisfy the requirements of §1031 ... " Ltr. Rul. 8046122. Thus, prior to TRA '84, the Service took the position that simultaneity was a requirement for §1031 treatment. However, see, Rev. Rul. 57-451, 1957-2 C.B. 295 in which IRS held that simultaneity was not required in the case of an §1036 exchange.

4. Status of the law prior to TRA '84. Notwithstanding the announced position of the IRS
in Ltr. Rul. 8046122 to the contrary, case law indicated that simultaneity was not, per se, a requirement for qualification under §1031. Starker v. United States, 602 F.2d 1341 (9th Cir. 1979); Starker v. United States, 602 F. Supp. 864 (D.C. Ore. 1977); Redwing Carriers, Inc. v. Tomlinson, 399 F.2d 652 (5th Cir. 1968); and Rutherford v. Commissioner, 37 CCH T.C.M. 1851-77 (1978). See, also, Rev. Rul. 61-119, 1961-1 C.B. 395.

5. Time and identification limits imposed by TRA '84. Because of uncertainty and potential abuses in deferred exchanges under §1031, Congress acted to permit deferred exchanges under certain limited conditions with its enactment of §1031(a)(3) in TRA '84. Specifically, the General Explanation of the Revenue Provisions of the Tax Reform Act of 1984, pages 243-247 (Staff of Joint Committee on Taxation) provides the following reasons for enactment of §1031(a)(3): (1) in deferred exchanges, the transaction more closely resembles a sale of one property following by a purchase of a second property rather than an exchange; (2) the rationale for deferred treatment in like kind exchanges regarding the difficulty of valuing property which is exchanged solely or primarily for similar property is less applicable to deferred like kind exchanges because in such deferred exchanges the transferred property must be valued at a specific or near-specific dollar amount in order to determine the aggregate value of the properties that the taxpayer may receive in the future; and (3) Congress was concerned that the like kind exchange rules, absent time limitations, significantly expanded the ability of taxpayers to avoid recognition of gain on deferred payment sales, especially when used in conjunction with the installment sales rules. Specifically, §1031(a)(3) requires the following:

a. Identification. Property will not be treated as like kind property unless the property is 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.

b. Receipt of property. Property will not be treated as like kind property unless it is received no later than the earlier of: (1) the day which is 180 days after the date on which the taxpayer transfers the property.
relinquished in the exchange; or (2) the due date (determined with regard to extensions) for the transferor's return of the tax imposed for the taxable year in which the transfer of the relinquished property occurs.

6. Final regulations governing deferred exchanges. On May 1, 1991, final regulations were issued by Treasury governing deferred exchanges which apply to transfers of property made on or after June 10, 1991 (subject to certain rules applicable to transfers made on or after May 16, 1990). Reg. §1.1031(k)-1(o). The final regulations are very similar to the prior proposed regulations issued on May 16, 1990. The new regulations define "deferred exchanges," establish operating rules for the identification and receipt of replacement properties, create four safe harbors from the constructive receipt principles of general tax law, and provide additional guidance in the computation of gain, loss and basis in deferred exchanges.

a. The issuance of the final regulations is likely to give a boost to the already accelerating use of deferred exchanges by taxpayers. Recent changes in the tax laws have increased capital gains rates and corporate rates and have curtailed the use of installment sales as well. By contrast, the advantages of tax deferred exchanges now look even better as a result of the clarification and liberalization of the deferred exchange rules contained in the new regulations.

7. Definition of deferred exchange.

a. Reg. §1.1031(k)-1(a) defines a deferred exchange as follows:

"... an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the "relinquished property") and subsequently receives property to be held either for productive use in a trade or business or for investment (the "replacement property")."

b. The rather broad definition of a deferred exchange set forth above must be read in conjunction with the balance of the final
regulations which impose some very important limitations.

(1) Reg. §1.1031(k)-1(a) states that any replacement property that otherwise meets these definitional criteria will nevertheless be treated as boot. (i.e., non-qualifying property) unless all the requirements regarding the identification and receipt of the replacement property established under Reg. §§1.1031(k)-1(b), (c) and (d) are satisfied.

(2) In addition to singling out the identification and receipt requirements for special emphasis, Reg. §1.1031(k)-1(a) also highlights the other major issue in deferred exchanges -- actual or constructive receipt of boot attributable to the taxpayer's efforts to secure performance by other parties to the deferred exchange.

(3) The final regulations, like the prior proposed regulations, do not apply to the so-called "reverse-Starker" transactions in which the taxpayer receives replacement property prior to the date on which the taxpayer transfers the relinquished property. The Service announced in the preamble to the final regulations that it had concluded that the deferred exchange rules of §1031(a)(3) do not apply to reverse-Starker transactions. Preamble to T.D. 83-46. However, the Service also indicated it would continue to study the applicability of the general rules of §1031(a)(1) to these transactions. Id.

(a) Some taxpayer representatives are relying on a variety of techniques to accomplish the same end result as the reverse-Starker exchange. These includes "parking" the relinquished property with a qualified intermediary and the use of options discussed in III.D.1. supra.

8. Identification requirements.

a. Section 1031(a)(3)(A) requires that any replacement property to be received in a
deferred exchange be "identified" within 45 days after the taxpayer transfers the relinquished property. Reg. §§1.1031(k)-1(b), (c) and (e) establish the parameters for this identification process. As a practical matter, the 45-day identification requirement is the most difficult of all the §1031(a)(3) requirements to meet. If the taxpayer does not already have the luxury of a running start in finding suitable replacement property prior to the closing on the transfer of the relinquished property, it is frequently very difficult to locate suitable replacement property within 45 days of the date of transfer. Consequently, it is usually prudent to begin the process of locating acceptable replacement properties prior to executing an exchange agreement or, if that is not possible, to at least defer closing as much as possible in order to buy extra time for the taxpayer to accomplish this important objective.

b. Reg. §1.1031(k)-1(b)(2) provides that the 45-day period, which is referred to in the regulations as the "identification period" begins on the date the taxpayer transfers the relinquished property and ends at midnight on the 45th day thereafter.

(1) If two or more relinquished properties are transferred on different dates, the identification period begins on the date of the earliest transfer. Reg. §1.1031(k)-1(b)(2)(iii).

(2) For purposes of determining the date on which the identification period ends, §7503 (relating to the time for performance of acts where the last day falls on a Saturday, Sunday or legal holiday) does not apply. In other words, if the 45-day period ends on July 4, the identification period will terminate on that date notwithstanding the fact that it is a national holiday. Moreover, no discretion is given to the Service to extend the identification period, regardless of hardship or other good cause shown. Reg. §1.1031(k)-1(c) contains the exclusive rules for identification of replacement property. Replacement property may be identified in one of two ways:
(a) Property will be treated as having been identified if it is "... designated as replacement property in a written document signed by the taxpayer and hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period to either the person obligated to transfer the replacement property to the taxpayer (regardless of whether such person is a 'disqualified person' under Reg. §1.1031(k)-1(k)) or any other person involved in the exchange other than the taxpayer or a 'disqualified person.'" A written agreement which meets all the identification requirements described in the preceding sentence and which is signed by all parties to the transaction will also suffice, regardless of whether it is 'sent' to a person involved in the exchange. Reg. §1.1031(k)-1(c)(2).

(b) Any replacement property actually received by the taxpayer before the expiration of the identification period will in all events be treated as having been identified within such period. Reg. §1.1031(k)-1(c)(1).

c. Replacement property must be "unambiguously described" in the written document or agreement. Reg. §1.1031(k)-1(c)(3).

(1) Real property will be treated as unambiguously described if it is described by a legal description, street address, or a distinguishable name (e.g., the Mayfair Apartment Building). Reg. §1.1031(k)-1(c)(3).

(a) Query: What happens if there is an error in the legal description or address?

(b) While the use of a "distinguishable name" is now permitted in the final regulations (this was not included in the proposed regulations) it is advisable to not only identify the name of the building but also give a street address or legal description in
conjunction therewith. For example, if there are two or more Mayfair Apartment Buildings located in Atlanta, Georgia, would such a designation be sufficient?

(2) Identification of personal property must be made by specific description of the particular type of property. For example, a truck generally is unambiguously described if it is described by a specific make, model and year. Reg. §1.1031(k)-1(c)(3).

(3) Solely for purposes of the identification process, property which is incidental to a larger item of property will not be treated as a separate item of property and, thus, need not be separately identified. Reg. §1.1031(k)-1(c)(5).

(a) Property will be treated as incidental to a larger piece of property if it is typically transferred in conjunction with the larger property in standard commercial transactions and if the aggregate fair market value of all such incidental property does not exceed 15% of the aggregate fair market value of the larger item of property. Id.

i) For example, furniture, laundry machines and miscellaneous items of personal property will be treated as incidental to an apartment building with a fair market value of $1,000,000 provided that the aggregate fair market value of such items does not exceed $150,000. Reg. §1.1031(k)-1(c)(5) Ex. 2.

d. Alternative and/or multiple properties may be designated in accordance with the designation rules in certain circumstances enumerated in Reg. §1.1031(k)-1(c)(4).

(1) Reg. §1.1031(k)-1(c)(4) provides that, regardless of the number of relinquished properties transferred by the taxpayer in an integrated transaction, the taxpayer must meet one of two alternative tests if he wishes to designate alternative or multiples properties. This requirement
will allow the taxpayer to designate either:

(a) Three properties without regard to the fair market values of such properties; or

(b) 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.

(2) Reg. §1.1031(k)-1(c)(4)(ii) warns that if at the end of the identification period the taxpayer has identified more property than is permitted under the alternative rules described above, the taxpayer will be treated as if he had failed to identify any property under such rules. Fortunately, the regulations contain exceptions to this rather harsh rule for the following types of property:

(a) Property which is both identified and received within the identification period, and

(b) Property identified before the end of the identification period and received before the end of the exchange period (defined below) but only if identified property constituting at least 95% of the aggregate fair market value of all identified replacement property is actually received by the taxpayer before the end of the exchange period. For purposes of the 95% rule, the fair market value of each identified replacement property is determined as of the earlier of the date the property is received by the taxpayer or the last day of the exchange period. Id.

(3) The application of the 200% rule may be fraught with problems since the determination of fair market value is always subjective and inherently difficult to pin down. It will almost always be
prudent to rely upon the three property rule rather than the 200% rule whenever possible.

(4) It should be noted that the regulations do not require alternative or multiple property designations to be prioritized. In other words, the taxpayer is free to pick any of the alternative properties designated regardless of the order of designation.

e. A designation of property may be revoked at any time prior to the expiration of the designation period. Reg. §1.1031(k)-1(c)(6).

(1) Revocation may only be accomplished by a written document signed by the taxpayer and hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period to the person to whom the identification of the replacement property was sent or, if the original designation was accomplished in a written agreement signed by all of the parties, then revocation may be accomplished either by written amendment to the original agreement or by written notice from the taxpayer to all parties to the original written agreement. Id.

(2) An oral revocation will not be effective. Reg. §1.1031(k)-1(c)(6) and (7). Ex. 7.

f. Special rules are included for replacement property that is to be produced or constructed. Reg. §1.1031(k)-1(e) provides that replacement property need not be in existence at the time the relinquished property is transferred. In such case, the replacement property must still be identified in accordance with the general rules of Reg. §1.1031(k)-1(c), but special rules also apply. For example, if the identified replacement property consists of improved real property where the improvements are to be constructed, the description of the replacement property must satisfy the normal requirements of Reg. §1.1031(k)-1(c)(3) (i.e., legal description, street address or distinguishable name) and as much detail as provided regarding construction of the improvements as is practicable at the time the
identification is made. Reg. §1.1031(k)-1(e)(2)(i).

g. The dates of identification and receipt of replacement property must be reported on Form 8824 which must be filed in connection with the exchange transaction.

9. Requirements for receipt of identified replacement property.

a. Section 1031(a)(3)(B) provides that property otherwise qualifying as replacement property and which has been properly identified within the applicable identification period must also be received by the taxpayer within a specified time period. The rules governing receipt of identified replacement property are contained in Reg. §§1.1031(k)-1(b) and (d).

b. Reg. §1.1031(k)-1(b)(1) states that any property which is not received within the "exchange period" will be treated as boot. The "exchange period" is defined in Reg. §1.1031(k)-1(b)(2) as a period beginning on the first date the taxpayer transfers the relinquished property and ending on the earlier of (i) 180 days thereafter or (ii) the due date (including extensions) for the taxpayer's tax return for his taxable year in which the transfer of the relinquished property occurred.

(1) The rules for determining the commencement date of the exchange period as well as the date of expiration of the exchange period are identical to those applicable to the identification period. See, IV.E.8.b. supra.

c. Replacement property will only be deemed to have been received within the exchange period if the requirements of Reg. §1.1031(k)-1(d) are met.

(1) Such requirements will be satisfied if:

(a) The taxpayer receives the replacement property before the end of the exchange period, and
(b) The replacement property is substantially the same as the property identified.

If the taxpayer has identified more than one replacement property, these tests are applied separately to each replacement property. Reg. §1.1031(k)-1(d)(1).

(2) The use of the term "substantially the same" is somewhat vague but apparently incorporates a degree of tolerance for a minor change of circumstances. The regulations attempt to shed some light on this standard in examples which, unfortunately, raise as many questions as they answer.

(a) In one example the taxpayer identifies real property $Q$ as replacement property. Real property $Q$ consists of a barn on two acres of land and has a fair market value of $250,000 ($187,500 for the barn and underlying land as a unit, and $87,500 for the remaining land). At the taxpayer's direction, the other party purchases the barn and the land lying immediately beneath the barn for $187,500 and arranges to have it conveyed to the taxpayer. Simultaneously, the taxpayer paid the owner of the identified property $87,500 and acquired the remaining acreage. The example concludes that the barn and underlying land "differ in basic nature or character" from the property as a whole. Consequently, the taxpayer is not considered to have received substantially the same property as identified. Reg. §1.1031(k)-1(d)(2) Ex. 3.

(b) In a second example, the taxpayer identifies the replacement property consisting of two acres of unimproved land with a fair market value of $250,000. At the taxpayer's direction, the other party to the exchange purchases 1-1/2 acres of the identified property for $187,500 and transfers it to the taxpayer. The taxpayer pays $87,500 and acquires the remaining 1/2

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acre. The example concludes that the portion of the replacement property received by the taxpayer does not differ from the basic nature or character of the identified property as a whole. Moreover, the fair market value of the portion of the identified real property received by the taxpayer ($187,500) is 75% of the fair market value of the entire identified property as of the date of receipt. The example concludes that the taxpayer is considered to have received substantially the same property as identified. Reg. §1.1031(k)-1(d)(2) Ex. 4.

i) It is not clear whether the example is intended to establish 75% as a "bright line test" for the minimum necessary to meet the "substantially the same" standard (provided, of course, that the property is of the same nature or character).

d. Special rules also apply with respect to replacement property that is to be produced or constructed.

(1) Reg. §1.1031(k)-1(e)(3)(i) provides that, for purposes of determining whether the replacement property to be produced or constructed and which is actually received within the exchange period is to be treated as "substantially the same" as the property originally identified by the taxpayer, variations due to usual or typical production changes are not taken into account. However, if substantial changes are made in the property to be produced, the replacement property received will not be considered to be substantially the same property as identified.

(2) If the identified property is real property and improvements to be constructed are not completed prior to the expiration of the exchange, but title to the replacement property is nevertheless transferred to the taxpayer within the exchange period, the replacement property will be considered to
be substantially the same property as identified if:

(a) The replacement property received constitutes real property under local law, and

(b) If the construction had been completed on or before the date the taxpayer received the property, it would have been considered substantially the same as the property identified. Reg. §1.1031(k)-1(e)(3)(iii).

Notwithstanding the apparent generosity of this rule, Reg. §1.1031(k)-1(e)(4) provides that the value of any production or construction that takes place after the receipt of the replacement property by the taxpayer will not qualify as like kind property. Thus, any additional production occurring with respect to the replacement property after the property is received by the taxpayer will not be treated as the receipt of property of a like kind. Id.

10. Safe harbors from constructive receipt rules.

a. General. The primary interest of most tax practitioners in the new regulations focuses on the safe harbors that they establish. These safe harbors are important because they enable taxpayers to secure performance by the other parties to the exchange without the risk that the taxpayer will be deemed to have "constructively received" payment in the form of cash or other non-qualifying property. In Starker, the taxpayer accepted the unsecured promise of Crown Zellerbach to acquire and transfer replacement property to the taxpayer over a period of time. Few, if any, taxpayers today are willing to rely upon an unsecured promise to perform. Consequently, the safe harbors from the constructive receipt rules are extremely important to almost any taxpayer participating in a deferred exchange.

(1) Reg. §§1.1031(k)-1(f) and (g) contain guidelines for determining whether a taxpayer who transfers relinquished property in a deferred exchange will be treated as having actually or
constructively received cash or other non-qualifying property (i.e., "boot").

(a) The regulations begin with the premise that if a taxpayer actually or constructively receives boot in the full amount of the consideration for the relinquished property before he actually receives like kind replacement property, the transaction will be classified as a sale rather than a deferred exchange, even though the taxpayer may ultimately receive like kind property. Reg. §1.1031(k)-1(f)(1).

(b) The taxpayer will be in "actual receipt" of boot at the time he actually receives such boot or receives the economic benefit thereof. Reg. §1.1031(k)-1(f)(2).

(c) "Constructive receipt" of boot occurs when the boot is "... credited to the taxpayer's account, set apart from the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time or so that the taxpayer can draw upon it if notice of intention to draw is given." Id.

b. The regulations established four limited safe harbors to facilitate securing performance by the other parties to a deferred exchange without running afoul of the constructive receipt rules. The safe harbors are contained in Reg. §1.1031(k)-1(g). In many ways, these safe harbor rules are surprisingly liberal and go much further than the Service has been willing to go in (for example) the installment sale area.

(1) Since Congress did not delegate the authority to establish substantive law when it added §1031(a)(3) as part of TRA '84, the establishment of the safe harbors must be regarded as "interpretive regulations" issued under the Service's general interpretive authority granted by §7805. Consequently, the regulations do not have the force of law but presumably will be respected by the courts unless they
determine that the Service has exceeded its interpretive authority in issuing the regulations.

(2) One of the questions most frequently raised to thedraftsmen of the proposed regulations governing deferred exchanges was whether the safe harbors were mutually exclusive. The final regulations addressed this issue by specifically providing that more than one safe harbor can be used for the same deferred exchange, but the terms and conditions of each safe harbor must be separately satisfied. Thus, it is likely that if a qualified intermediary is to be used the taxpayer may want to combine this with a qualified escrow as well in order to provide additional security for performance.

c. The first safe harbor -- security or guaranty arrangements.

(1) Reg. §1.1031(k)-1(g)(2) provides that the determination of whether the taxpayer in a deferred exchange has actually or constructively received boot will be made without regard to the fact that the other party's obligation to transfer replacement property to the taxpayer is secured or guaranteed by any or all of the following:

(a) A mortgage, deed of trust, or other security interest in property (other than cash or a cash equivalent);

(b) A standby letter of credit that satisfies all the requirements of Reg. §15A.453-1(b)(3)(iii) and which precludes the taxpayer from drawing on the letter of credit except upon a default by the other party to the exchange to transfer qualified replacement property to the taxpayer; or

(c) A guarantee of a third party.

(2) There may be some practical problems associated with the use of a standby letter of credit if the terms of Reg. §1.1031(k)-1(g)(2)(i)(B) are applied literally. Under

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the conditions of this regulation, the letter of credit must be non-negotiable, non-transferable (except in connection with the underlying obligation that it secures) and must provide that it cannot be drawn upon in the absence of a default on the obligation which it secures. Few, if any, commercial lenders would issue a letter of credit in which the exercise was dependent upon the existence of a "default" in an underlying obligation. This places the issuer of the letter of credit in the position of determining whether or not there has been a default under a legal document. Under normal commercial practices, the letter of credit could be drawn upon the presentation of a draft accompanied by a sworn statement that there has been a default on the underlying obligation (i.e., the existence of a default need not be determined by the issuer of the letter of credit -- the issuer may simply rely upon the sworn statement of the holder of the letter of credit). Hopefully, the Service will interpret this regulation consistent with normal commercial practices in this regard. Moreover, what happens if the other party to the exchange is adjudicated bankrupt prior to the expiration of the time for it to acquire and convey the replacement property? Technically, there is no default until the expiration of the exchange period but the bankruptcy of the other party makes it clear that it will not fulfill its obligation to acquire and convey replacement property. May this be treated as an anticipatory default thereby enabling the taxpayer to draw upon the standby letter of credit? Finally, it should be noted that the period for exercise of the standby letter of credit should extend at least a few days after the expiration of the exchange period, thereby enabling the taxpayer to determine whether or not the other party to the exchange has fulfilled (or failed to fulfill) its obligations under the exchange agreement and still be able to exercise its rights as a secured party under the letter of credit.

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(3) The guarantee of an obligation to acquire and convey replacement property may be a very useful vehicle to secure performance. If properly structured, the guarantee should not only guarantee performance on an after-tax basis by the other party to the exchange but also contain an obligation for payment of liquidated damages based upon any adverse tax consequences resulting to the taxpayer from a failure to complete the tax deferred exchange. The guarantee should also be a guarantee of "payment" and not of "collection," in order that the taxpayer may proceed directly against the guarantor in the event of a default.

(4) Reg. §1.1031(k)-1(g)(2)(ii) sounds a warning that if the taxpayer has an immediate ability or unrestricted right to receive money or other property pursuant to the security or guaranty agreement, the benefits of the safe harbor will no longer be available. For example, if the taxpayer had a right to draw upon the letter of credit in the absence of a default, he would be deemed to have constructively received monies from the letter of credit at that time.

d. The second safe harbor -- qualified escrow accounts and qualified trusts.

(1) The actual and constructive receipt rules will also be applied to the taxpayer in a deferred exchange without regard to the fact that the obligations of one or more of the other parties to the exchange are or may be secured by cash or a cash equivalent held in a "qualified escrow account" or in a "qualified trust." Reg. §1.1031(k)-1(g)(3).

(2) A "qualified escrow account" is one in which the escrow holder is neither the taxpayer nor a "disqualified person" (as defined in Reg. §1.1031(k)-1(k) and discussed in subparagraph (5) below), and the taxpayer's rights to receive, pledge, borrow or otherwise obtain the benefits of the cash or cash equivalent held in escrow are limited to the circumstances described in Reg. §1.1031(k)-1(g)(6) (see, discussion - 81 -
in Part (4) below). Reg. §1.1031(k)-1(g)(3)(ii).

(3) A "qualified trust" is a trust in which the trustee is neither the taxpayer nor a "disqualified person," and the taxpayer's rights with respect to any cash or cash equivalent held by the trustee are restricted as provided in Reg. §1.1031(k)-1(g)(6).

(4) The limitations upon the taxpayer's access to any cash or cash equivalent held in a qualified escrow or a qualified trust are set forth in Reg. §1.1031(k)-1(g)(6). These restrictions require that the taxpayer's rights to any cash or cash equivalent held in a qualified escrow or qualified trust must be restricted until:

(a) After the expiration of the identification period if the taxpayer has not identified any replacement property within the identification period;

(b) After the taxpayer has received all of the identified replacement property to which he is entitled;

(c) If the taxpayer has identified replacement property, then after the later of the end of the identification period or the occurrence of a material and substantial contingency which relates to the deferred exchange, which is provided for in writing, and which is beyond the control of the taxpayer or a disqualified party (e.g., the replacement property will only be acquired if it could be rezoned for multi-family use); or

(d) After the end of the exchange period.

Reg. §1.1031(k)-1(g)(6) requires that these restrictions be specifically stated in the exchange agreement.

(5) The definition of a "disqualified person" is contained in Reg. §1.1031(k)-1(k). Under this provision, a person will be
deemed to be a "disqualified person" to the taxpayer if:

(a) Such person and the taxpayer have a relationship described either in §267(b) or §707(b) (subject to certain modifications).

i) Reg. §1.1031(k)-1(g)(3)(iii)(A) provides that, in the case of a qualified trust, the relationship between the taxpayer and the trustee will not be considered a relationship under §267(b).

Caveat: If the qualified trust is to be used in conjunction with a qualified intermediary the exemption from §267(b) for the relationship between the taxpayer and the trustee will apply in the case of the qualified trust but not in the case of the qualified intermediary. This is a "glitch" in the regulations which hopefully will be cured in the future.

(b) Such person acts as a taxpayer's agent, including performing services for the taxpayer as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the two-year period ending on the date of the transfer of the first of the relinquished properties (but, in making such determination, the performance of services in connection with the exchange itself or a routine financial, title insurance, escrow or trust services for the taxpayer by a financial institution, title insurance company or escrow company will be ignored); or

(c) The person is related to one of the taxpayer's "agents" (as defined above).

(6) It is important to note (and frequently overlooked) that the qualified escrow and the qualified trust are intended as passive vehicles to secure the buyer's performance of his obligations to acquire and convey

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replacement property to the taxpayer. If the escrow agent or trustee assumes a more active role (e.g., if such party contracts to purchase replacement property and convey it to the taxpayer), the escrow agent or trustee must also qualify as a qualified intermediary (discussed in paragraph (e), infra).

(7) Reg. §1.1031(k)-1(g)(3)(v) provides that the taxpayer may receive boot "from a party to the exchange," but not from a qualified escrow account or a qualified trust, without affecting application of the safe harbor. The clear implication of this portion of the regulations is that, if the taxpayer receives any boot from the qualified escrow or qualified trust prior to the occurrence of an event described in Reg. §1.1031(k)-1(g)(6), the benefits of the safe harbor may be lost. Consequently, if the taxpayer is to receive boot prior to the occurrence of a "(g)(6) event," the prudent course to follow is to be certain that the boot is paid directly from another party to the exchange to the taxpayer rather than from monies held in escrow or in trust.

(8) In this day and age when banks, savings and loans and insurance companies routinely go into bankruptcy or are taken over by federal regulators, taxpayers and their advisers must be concerned that the obligation of the other party to the exchange (or a qualified intermediary) be secured by any cash or cash equivalent held in a qualified escrow or a qualified trust. Under the laws of most states, the mere existence of the qualified escrow or qualified trust does not per se create a security interest in the monies held in escrow or in trust.

(a) See, In re San Diego Realty Exchange, Inc. v. Vaca, 132 B.R. 424 (Bkrtcy. S.D. Cal. 1991) in which the debtor, which performed services as a qualified intermediary and qualified escrow agent, entered into an exchange agreement with Vaca. The debtor received Vaca's property, sold it to a
third party, deposited the proceeds of sale in its general account and later purchased and deeded replacement property to Vaca. Unfortunately for Vaca, the acquisition and deeding of the replacement property occurred within 90 days of the filing of the debtor's bankruptcy petition. The Bankruptcy Court refused to accept Vaca's argument that the debtor held funds in a "constructive trust" for Vaca because the funds were commingled with the debtor's other funds (and those of other exchange clients). Thus, the deeding of the replacement property to Vaca was held to be a preferential transfer.

(b) It will be difficult, if not impossible, to created a perfected security interest in the liquid proceeds held by the escrow agent or trustee under the laws of most states. The safest course of action in light of San Diego Realty Exchange is probably to use a qualified trust (in order to create a stronger fiduciary relationship as opposed to a qualified escrow) and to require the proceeds from the sale of the taxpayer's property to be held by the trustee in a segregated account at all times.

e. The third safe harbor -- qualified intermediaries. Often the prospective buyer of the taxpayer's property will refuse to cooperate in structuring a tax deferred exchange. In such cases, taxpayers have frequently attempted to use an intermediary to accomplish the sale of the relinquished property and at the same time facilitate a deferred exchange under §1031. The intermediary would typically enter into an exchange agreement with the taxpayer pursuant to which the taxpayer would convey its property to the intermediary in exchange for the intermediary's agreement to acquire and convey replacement property to the taxpayer. The principal tax risk was that the intermediary would be found to be the taxpayer's agent and that, as a consequence, the receipt of money or other non-like kind property by an intermediary

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would be treated as having been received by the taxpayer.

The deferred exchange regulations now offer a very generous safe harbor for the use of a "qualified intermediary" to facilitate an exchange with the promise that, if complied with, the intermediary will not be treated as a taxpayer's agent for tax purposes and the taxpayer will not be treated as being in actual or constructive receipt of money or other non-like kind property held by the intermediary. See, Reg. §1.1031(k)-1(g)(4)(i).

(1) A "qualified intermediary" is defined in Reg. §1.1031(k)-1(g)(4)(iii) as "... a person who (A) is not a taxpayer or a disqualified person [as defined in Reg. §1.1031(k)-1(k)], and (B) enters into a written agreement with the taxpayer (the "exchange agreement") and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer."

Note that the requirement in the former proposed regulations that the intermediary also receive a fee for its services has been omitted from the final regulations. However, this may be a meaningless change since the final regulations require that the intermediary be an independent third party who is not likely to waive such a fee.

(2) The exchange agreement that is required to be entered into by the taxpayer and the intermediary must include the following:

(a) The agreement must require that the intermediary acquire the relinquished property from the taxpayer, transfer the relinquished property, acquire the replacement property, and transfer the replacement property to the taxpayer. Reg. §1.1031(k)-1(g)(4)(iii)(B); and

(b) Restrict the taxpayer's rights to receive, pledge, borrow, or otherwise
obtain the benefits of money or other property held by the intermediary to the extent required by Reg. §1.1031(k)-1(g)(6). Reg. §1.1031(k)-1(g)(4)(ii).

(3) Direct deeding is specifically sanctioned in the final regulations in connection with the qualified intermediary safe harbor. Although the qualified intermediary is required to both acquire and convey the relinquished property, Reg. §1.1031(k)-1(g)(4)(iv)(B) provides that an intermediary will be treated as acquiring and transferring the relinquished property if the intermediary enters into an agreement with a person other than the taxpayer for the transfer of the relinquished property to that person and, pursuant to that agreement, the relinquished property is transferred to that person (i.e., direct deeded from the taxpayer to the ultimate purchaser). It should be noted that direct deeding is sanctioned only if the intermediary first establishes contractual privity with the purchaser of the relinquished property. However, Reg. §1.1031(k)-1(g)(4)(v) also authorizes the taxpayer to enter into a contract for the conveyance of the property and specifically assign that contract to the intermediary (which presumably may be coupled with a direct deeding) provided that all parties to the agreement are notified in writing of the assignment on or before the date of the relevant transfer of property. Similar rules are also provided with respect to direct deeding in connection with the acquisition of the replacement property by the qualified intermediary and ultimate conveyance by it to the taxpayer. See, Reg. §1.1031(k)-1(g)(4)(iv)(C). Direct deeding is almost essential because of concerns regarding compliance with environmental laws and the possible exposure that the intermediary might face if it were included in the chain of title.

(4) Many taxpayers prefer to use the qualified intermediary safe harbor in conjunction with a qualified escrow in order to better secure performance by the intermediary and
protect, to the extent possible, the monies and other properties held by or for the intermediary from claims of the intermediary's creditors, including a bankruptcy trustee. This tandem use of the safe harbors is specifically sanctioned in Reg. §1.1031(k)-1(g)(1) provided that all the terms and conditions of each safe harbor are separately satisfied.

(5) The taxpayer may receive boot directly from another party to the transaction in conjunction with the use of a qualified intermediary but, just as in the case of a qualified escrow and qualified trust, the receipt of any monies from the qualified intermediary (or the qualified escrow agent) prior to the occurrence of an event described in Reg. §1.1031(k)-1(g)(6) will not be permitted. See, Reg. §1.1031(k)-1(g)(4)(vii).

f. Fourth safe harbor -- interest and growth factors.

(1) Reg. §1.1031(k)-1(g)(5) provides that the right of a taxpayer to receive interest or a growth factor with respect to the deferred exchange will not, in and of itself, cause the taxpayer to be deemed to have actually or constructively received boot. Prior to the inclusion of this safe harbor in the regulations (and its counterpart in the prior proposed regulations), a number of practitioners questioned whether the taxpayer could receive interest earned on funds held by an intermediary and generally suggested that all such funds should belong to, and be retained, by the intermediary in order to avoid having the intermediary treated as the taxpayer's agent.

(2) Just as in the case of the other three safe harbors, the interest or growth factor safe harbor will not apply unless the taxpayer's right to receive the interest or growth factor are limited to the circumstances described in Reg. §1.1031(k)-1(g)(6) (discussed at IV.E.10.d.(4), supra).
Additional rules concerning interest or growth factors are also set forth in Reg. §1.1031(k)-1(h). This subsection of the regulations provides that the interest or growth factor rules will only apply to economic benefits which depend upon the length of time elapsed between the transfer of the relinquished property and the receipt of the replacement property. Reg. §1.1031(k)-1(h)(1).

(a) Query: What if the exchange agreement provides that, upon the taxpayer's transfer of the relinquished property, the transferee will deposit $100,000 (the value of the relinquished property) in escrow and that the taxpayer will be entitled to the interest or other return earned from the investment of the $100,000 by the escrow agent during the term of the escrow? It could be argued that the interest or growth factor is dependent not only upon the amount of time elapsed between the transfer date and the receipt of the replacement property but also upon the nature of the investment made by the escrow agent. Although Reg. §1.1031(k)-1(h)(1) does not provide a clear answer on this point, both Treasury and Service representatives have stated without reservation at open meetings of the American Bar Association Tax Section that such a provision would qualify as an "interest or a growth factor."

(b) Regardless of whether the interest or growth factor is stated in terms of the actual earnings derived from investment of the monies held in escrow or is stated in another manner, the deferred exchange regulations do not address who is to be taxed on income held in a qualified escrow or qualified trust. Section 468(B)(g) provides that nothing in any provision of the law will be construed as providing that an escrow account, settlement fund or similar fund is not subject to current income tax. The Treasury has deferred promulgating rules on the taxation of
earnings within a qualified escrow or qualified trust until regulations under §468(B)(g) are published. See, preamble to T.D. 8346. Thus, there is still some question as to whose taxpayer identification number should be used when an escrow agent or trustee invests funds held in a qualified escrow or qualified trust.

If the taxpayer is entitled to receive interest or a growth factor it will be treated as interest, regardless of whether it is paid to the taxpayer in the form of cash or in property (including property of a like kind). Reg. §1.1031(k)-1(h)(2).

g. Transactional expenses. The final regulations have added a significant corollary to the safe harbor rules. Under Reg. §1.1031(k)-1(g)(7), the taxpayer's receipt of, or right to receive any of, the following items will be disregarded in determining whether all the terms and conditions of the qualified intermediary, qualified escrow and qualified trust safe harbors have been met.

(1) Items that a seller may receive as a consequence of the disposition of property and that are not included in the amount realized from the disposition of property (e.g., prorated rents), and

(2) Transactional items that related to the disposition of the relinquished property or to the acquisition of the replacement property and that appear under local standards in the typical closing statement as a responsibility of buyer or seller (e.g., commissions, prorated taxes, recording or transfer taxes, and title company fees).

11. Boot "netting" when the relinquished property is encumbered by a mortgage. As noted in IV.C.4.c., supra, if both the relinquished property and the replacement property are encumbered by mortgages at the time of an exchange, the taxpayer may "net" the mortgages for purposes of computing the amount of boot received in the exchange, and only the excess of the mortgage balance on the relinquished property over the mortgage balance of the
replacement property will be treated as boot. In the case of a deferred exchange, however, it will presumably not be known at the time the relinquished property is conveyed whether the replacement property will be encumbered or, if so, what the outstanding balance of the mortgage encumbering the replacement property will be. The deferred exchange regulations do not directly address the application of the boot netting rules to a deferred exchange, but an example contained in one portion of the regulations illustrates that a deferred netting of mortgages will be allowed.

Reg. §1.1031(k)-1(j) Ex. 5.

a. Query: If the "taxpayer" is a partnership, will the constructive distribution rules of §752(b) (which treat any relief from liability as a constructive distribution of cash to the partners) also defer the deemed distribution until the replacement property is received? No guidance has as yet been provided on this issue.

12. Installment reporting of boot in deferred exchange.
The interrelationship of §§453 and 1031 is discussed at IV.C.4.d., supra. On November 2, 1992, proposed regulations were issued which provide guidance on coordinating the deferred exchange rules with the installment sale provisions. See, Prop. Reg. §1.1031(k)-1(j)(2).
The principal provisions of the proposed regulations are as follows:

a. Deferred exchange safe harbors will apply for installment sale purposes. The qualified escrow, qualified trust and qualified intermediary safe harbors of Reg. §§1.1031(k)-1(g)(3) and (4) will also apply for purposes of determining whether a taxpayer has either actually or constructively received a payment under §453 and Temp. Reg. §15A.453-1(b)(3)(i). Prop. Reg. §1.1031(k)-1(j)(2)(i) and (ii).
Thus, subject to the general provisions of §§453 and 453A, taxpayers who comply with the deferred exchange safe harbor requirements may report any gain to be recognized on the deferred exchange on the installment basis.

(1) The right to utilize the installment sale provisions to defer recognition of gain in a deferred exchange is conditioned upon a "bona fide intent" on the part of the
taxpayer to enter into and complete a deferred exchange. Prop. Reg. §1.1031(k)-1(j)(2)(iii). Thus, if the taxpayer entered into a deferred exchange agreement in December which he had no intention of completing but was designed solely to shift recognized gain into the next taxable year, such gain must be reported in the earlier year.

(a) The proposed regulations offer no guidance on how the Service is to determine whether the taxpayer had the requisite bona fide intent. However, this will necessarily involve a facts and circumstances evaluation.

(2) The protection afforded by the proposed regulations will expire upon the earlier of:

(a) The time the safe harbor ceases to apply under the deferred exchange rules, or

(b) The end of the exchange period. Prop. Reg. §1.1031(k)-1(j)(2)(i) and (ii).

b. Receipt of third party note. Receipt of a purchase money note from the buyer of property will not be regarded as a "payment" for purposes of the installment sale rules unless such note is payable on demand or is readily tradable. §§453(f)(3) and (4). However, receipt of a note issued by a party other than the buyer will be treated as a payment and the amount of such payment will be equal to the fair market value of the note. See, Temp. Reg. §15A.453-1(b)(3). Prop. Reg. §1.1031(k)-1(j)(2)(ii) creates a special exception to this third party note rule that applies when a deferred exchange is accomplished through the use of a qualified intermediary. In such a case, if the qualified intermediary obtains a purchase money note from the ultimate purchaser of the relinquished property and transfers the note to the taxpayer, the note will be regarded as a note received from the "buyer" of the property (even though the intermediary, not the ultimate purchaser, is the "buyer" of the taxpayer's property).
V. Revenue Reconciliation Act of 1993 Changes Affecting Real Estate Dispositions.

A. Passive Loss Changes.

1. One of the principal objectives of the Tax Reform Act of 1986 was to put an end, once and for all, to the widespread use of tax shelters by high income taxpayers to minimize or avoid taxes on their regular sources of income. The principal Congressional response to the tax shelter dilemma was the addition of §469 of the Code which imposes limitations on the use of losses and credits from "passive activities" to shelter income from other sources. Section 469 requires taxpayers to whom it applies to divide all of their income, deductions and credits into two separate "baskets." The first basket (passive basket) consists of items attributable both to trade or business activities in which the taxpayer does not materially participate and to certain rental activities. All other income, deductions and credits are included in a second basket (active or general basket). Deductions generated by a passive basket activity may only be used to offset income from the same passive basket (and hence, may not be applied to shelter income from the general basket) until the taxpayer disposes of his entire interest in the passive activity. Thus, a taxpayer may not use losses from a passive activity to shelter his wages, portfolio income or his income from a trade or business in which he materially participates. The limitations of §469 apply to passive activity losses and passive activity credits of individuals, estates, trusts, certain closely held C corporations and personal service corporations. §469(a).

2. There are two types of passive activities:

   a. Trade or business activity in which the taxpayer does not materially participate (§469(c)(1)); and

   b. A rental activity, regardless of whether the taxpayer materially participates in the activity (§§469(c)(2) and (4)).

3. Real estate professionals have argued since the passage of §469 that the automatic classification of all rental activities as passive activities unfairly discriminates against them. For example, a real estate professional who receives a
substantial portion of his income in the form of commissions or fees for the sale, development or management of real estate (which would be included in the general basket) could not offset his losses from rental properties against such income, even though he devoted a substantial amount of his time and effort to the management of such rental properties.

4. The Revenue Reconciliation Act of 1993 ("RRA '93") modified §469 to exempt certain real estate professionals from the automatic classification of their rental activities as passive activities. In other words, the rental activities of these real estate professionals will be treated like any other trade or business and, if the professional "materially participates" in the rental activity, gains or losses from such rental activity will not be restricted under §469.

a. The new relief provided under RRA '93 will only be available to a taxpayer who meets the requirements of §469(c)(7)(B) (referred to herein as a "Qualified Taxpayer"). A Qualified Taxpayer is one who meets both of the following requirements during the taxable year:

(1) More than fifty percent of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in "real property trades or businesses" in which the taxpayer materially participates, and

(2) The taxpayer must perform more than 750 hours of services during the taxable year in "real property trades or businesses" in which the taxpayer materially participates.

(a) In the case of married taxpayers who file a joint return, one of the spouses must individually meet the 750 plus hour requirement.

This is an annual test and must be met by the taxpayer in each taxable year in which he or she desires to take advantage of the relief afforded by this new provision. Personal services performed as an employee will not be treated as performed in a real property trade or business unless the employee is a "5 percent
owner" (as defined in §416(i)(1)(B)) of the employer.

b. A special rule applies in determining whether a closely held C corporation will be regarded as a Qualified Taxpayer. Under §469(c)(7)(D)(i), such a corporation will be regarded as a Qualified Taxpayer for a taxable year if more than fifty percent of its gross receipts for such taxable year are derived from real property trades or businesses in which the corporation materially participates.

(1) See, §469(h)(4) re: the standards for material participation by a closely held C corporation.

c. "Real property trades or businesses" are defined in §469(c)(7)(C) as "... any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business."

d. Taxpayers may treat each rental activity as a separate activity or may elect to treat all interests in rental real estate as one activity. §469(c)(7)(A). Since a Qualified Taxpayer must satisfy the material participation test with respect to each activity in order to remove profits and losses generated by such activity from the restrictions of §469, most taxpayers will presumably elect to aggregate their rental properties.

(1) Query: Will a taxpayer be permitted to regroup his rental businesses into a single activity in 1994 to take advantage of the new election to aggregate rental properties into a single activity? Prop. Reg. §1.469-4(g) appears to permit a fresh start in 1994 because the change in law under RRA '93 will presumably constitute a "material change in the facts and circumstances" which the taxpayer may reasonably conclude makes his previous grouping of rental properties inappropriate.

e. The new changes are effective in taxable years beginning after December 31, 1993. Passive losses carried over from taxable years prior to
the effective date will be treated as losses from a former passive activity.

5. RRA '93 also added new §108(b)(2)(F) which adds passive loss and passive credit carryovers to the list of tax attributes to be reduced as a price for excluding certain cancellation of indebtedness income under §108(a).

B. Impact of Tax Rate Changes Upon Structuring Real Estate Transactions.

1. Prior to TRA '86 taxpayers and their advisers devoted much time and attention to converting ordinary income into capital gain in the case of property that was ripe for development. This effort was motivated by the large disparity in marginal rates between capital gains and ordinary income. TRA '86 eliminated this difference and, although a small disparity was restored in later tax acts, the incentive to engage in this type of planning was minimal at best. However, as a result of the changes in marginal rates effected by RRA '93, the difference between the top marginal rate on ordinary income of individual taxpayers (39.6%) and capital gains (28%) has now grown to 11.6%. This degree of disparity may once again motivate taxpayers to dust off their plans from the pre-TRA '86 era to convert ordinary income into capital gain.

   a. For example, the most popular type of planning was a sale of property which was to be developed to a controlled corporation in exchange for an installment note. The purchasing corporation would then take a stepped-up "cost basis" in the property under §1012 (provided that the transaction is recognized as a sale for tax purposes and provided that the purchase price equals fair market value). Subsequent sales of lots developed from the property would generate ordinary income to the corporation, but the profit derived from the original sale of the undeveloped property by the taxpayer to his controlled corporation would qualify for long term capital gain treatment.

2. Potential problem areas must be considered in any proposed installment sale of land which is designed
to provide increased cost basis to a controlled corporation.

a. Installment notes may be treated as "debt securities" received in a §351 exchange for property; transferor's lower cost basis carries over and creates additional taxable income to corporation. Camp Wolters Enterprises, Inc. v. Commissioner, 230 F.2d 555 (5th Cir.), cert. denied, 352 U.S. 826 (1956); Campbell v. Carter Foundation Production Co., 322 F.2d 827 (5th Cir. 1963); and George A. Nye, 50 T.C. 203 (1968), acq. 1969-2 C.B. xxv.

(1) However, while corporation receives no step-up in cost basis, interest is generally deductible and debt securities may be redeemed without dividend equivalence.

b. A dreaded alternative is that installment notes may be treated as "equity" and the equivalent of stock received in a §351 exchange with the following results:

(1) Transferor's lower cost basis carries over to corporation;

(2) Corporation receives additional taxable income when it sells developed lots and, after corporate taxes (if it is a C corporation), additional earnings to support a dividend distribution;

(3) Corporation loses deduction for interest paid on the installment note; and

(4) Interest and principal payments received by transferor will be taxed as dividends.


c. Factors which lead to adverse decisions noted in b, above, include:

(1) Inadequate "thin" capitalization;

(2) Identity of interests between those who own stock and notes;

(3) Intention not to enforce notes, e.g., interest and principal not paid when due;

(4) Notes subordinated to general creditors;

(5) Inflated price; and

(6) No overriding business purpose.

d. Installment sale may be respected if there is demonstrated likelihood of early repayment. Sun Properties v. United States, 220 F.2d 171 (5th Cir. 1955) (income from transferred warehouse sufficient to pay expenses and notes); Piedmont Corp. v. Commissioner, 388 F.2d 886 (4th Cir. 1968) ($10,000 cash and $160,000 notes equal value of option right to purchase land, and there was a reasonable probability that notes would be repaid. "Thin capitalization" alone not sufficient to negate a sale); Gyro Engineering Corp. v. United States, 417 F.2d 437 (9th Cir. 1969) (income from transferred apartment house was sufficient to pay expenses and notes. "Thin corporation" doctrine held not applicable); Hollywood, Inc., 10 T.C. 175 (1948), acq., 1948-1 C.B. 2 (sale of land to corporation which did not develop but, instead, resold in the same condition as when acquired); Evwalt Development Corp., 22 T.C.M. 220 (1963) (sale of land to corporation having "not negligible" capital, 14 months
after it was formed; and notes given for prior sales were paid promptly); Charles E. Curry, 43 T.C. 667 (1965), non-acq., 1968-2 C.B. 3, withdrawing acq., 1965-2 C.B. 4, on this point (sale of income-producing office building); Arthur M. Rosenthal, 24 T.C.M. 1373 (1965); Ainslie Perrault, 25 T.C. 439 (1955), acq., 1956-1 C.B. 5, aff'd., 244 F.2d 408 (10th Cir. 1957); Sheldon Tauber, 24 T.C. 179 (1955), acq., 1955-2 C.B. 9; Warren H. Brown, 27 T.C. 27 (1956), acq., 1957-2 C.B. 4 (each involving sale of business, and ascribing goodwill as an asset which augmented capital). The Brown decision suggests useful guidelines:

"... the apparent intention of the parties, the form of contract here in question, the reservation of title in the transferors until the full purchase price is paid, the obvious business considerations motivating the partners to cast the transaction in the adopted form, the substantial investment by the transferors in stock of the corporation, the superior position of the transferors' claims to the claims of other corporate creditors, the fact that the contract price was equal to the stipulated fair market value of the assets transferred thereunder, the contract provision calling for fixed payments to the partners without regard to corporate earnings, the provision requiring the payment of interest to the transferors at a reasonable rate, the absence of an agreement not to enforce collection, and the subsequent payment of all installments which became due under the contract during the years in issue ..." (27 T.C. at 35, 36).

e. Additional obstacles may also arise under the installment sale rules.

(1) Limitations on sales of property to a related party under §453(e). See, discussion under II.B.4.a., supra.

(2) If selling taxpayer is deemed to be a dealer with respect to the property sold, installment reporting will not be available on bulk sale of property. §§453(b)(2)(A) and 453(l).
(3) See, §§1274 and 483 if inadequate interest rate charged or interest is not paid annually.

(4) Caveat: Pledge rules under §453A(d) and interest toll charges for privilege of using installment reporting method under §453A(b) and (c). See, discussion under II.C., D., E., and F., supra.

f. Consider use of rolling options as alternative to installment sale. See, discussion in III.B., supra.

3. Taxpayer-seller may be adversely affected by the "ordinary income activities" of controlled corporation-purchaser.

a. Platting and other activity prior to sale may indicate that it was "held for sale." Browne v. United States, 356 F.2d 546 (Ct.Cl. 1966), which referred to "substantial personal development activities, plus use of sale to a controlled corporation which continued the development . . ." See, also, Tibbals v. United States, 362 F.2d 266 (Ct.Cl. 1966); Brown v. Commissioner, 448 F.2d 514 (10th Cir. 1971); Burgher v. Campbell, 244 F.2d 863 (5th Cir. 1957). Although the corporate entity may be recognized (Ralph E. Gordy, 36 T.C. 855 (1961), acq., 1964-1 C.B. 4) and the activities of the corporation will not be attributed to the selling stockholder (Whipple v. Commissioner, 373 U.S. 193 (1963)), nevertheless the selling shareholder's character as a "dealer" may be indicated because he has "utilized the company in his business," Tibbals v. United States, supra, or as stated in Burgher v. Campbell, because " . . . all of his buying and selling history (together with the sale of the land) to a corporation controlled by him and which immediately subdivided and sold lots from it, is ample evidence . . . that it was bought . . . for that purpose." (244 F.2d at 865).

b. Conclusion: One who is personally active in real estate development activities will be more exposed to "ordinary income" from a sale to a controlled corporation.
4. Query: If one sells for "nothing down" with installment payments as and when the corporation develops and sells the land, is there not a joint venture in which the seller is simply utilizing the corporation in his business, as in Whipple v. Commissioner, 373 U.S. 193 (1963)?