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Planning Tax Free Exchanges Under 1990 Proposed Tax Regulations

By
Alan R. Cerf

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PLANNING TAX FREE EXCHANGES UNDER 1990 PROPOSED TAX REGULATIONS

by

Alan R. Cerf, CPA, Ph.D.

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ABSTRACT

Like-kind exchanges under Section 1031 of the Internal Revenue Code are an important method of deferring the recognition of gain in real estate transactions. An investor in real estate with a substantial unrealized gain may wish to dispose of a parcel of property but still wish to have an investment in real estate. Section 1031 provides an opportunity to defer the unrealized gain.

Exchanges may be simultaneous. In other situations an investor may have located a buyer for the relinquished property but may not have located the replacement property. Deferred like-kind exchanges have been developed to provide the current non- recognition of gain under Section 1031 of the Internal Revenue Code when the replacement property is obtained at a later date than the disposal of the relinquished property.

The objective of this paper is to discuss the application of the tax free exchange rules under a new set of proposed internal revenue regulations set forth in 1990. These regulations provide needed guidance in the planning of deferred like-kind exchanges. Time requirements are specified for identification and receipt of replacement property as are methods of identifying replacement property. Limits on number and aggregate value of replacement properties are examined. Property not yet in existence or under construction may qualify in certain situations.

Prior to these regulations there was a problem of avoiding constructive receipt and at the same time providing for security prior to the purchase of the exchange property by the buyer. The proposed regulations provide four safe harbors under which the taxpayer will not be considered in actual or constructive receipt of money or other nonlike-kind property which would disqualify the exchange for nonrecognition of gain treatment.

In the final section there is a review of some of the basic concepts of Section 1031. Examples are given of determination of gain and the basis of replacement property when cash or "other property" is received in an otherwise non taxable exchange. The meaning of certain key concepts are discussed. This involves the meaning of "held for productive use in a trade or business or for investment," and the meaning of "like-kind" property.

The new regulations serve to provide significant help in planning for tax free exchanges. Now they exist they should be followed carefully.

Like-Kind Exchanges

Like-kind exchanges under Section 1031 of the Internal Revenue Code are an important method of deferring the recognition of income. The repeal of the capital gains deduction in the 1986 Revenue Act increased the motivation for taxpayers to avoid taxable transactions in real estate. The taxpayer must now pay tax on the entire gain at ordinary tax rates (maximum of 28 percent) whereas prior to 1986 a taxpayer only paid ordinary rates on 40% of the gain.

Investors in real estate may be involved in simultaneous exchanges of real estate. In other situations an investor may wish to dispose of a specified property and at the same time keep the funds invested in real estate. He or she may not have located the replacement property at the time a buyer has been located for the property to be relinquished.

Deferred Like-Kind Exchanges

Deferred like-kind exchanges have been developed to provide the current non-recognition of gain under Section 1031 of the Internal Revenue Code when the replacement property is obtained at a later date than the disposal of the relinquished property.

The objective of this paper is to discuss the application of the tax free exchange rules under a new set of proposed internal revenue regulations set forth in 1990. These new regulations provide guidance for deferred exchanges in real estate and for exchanges of entire businesses. This paper will consider only the exchange rules for real estate.

The evolution of the rules for deferred like-kind exchanges is described starting with the important "Starker" case in 1979 through the 1984 and 1989 Internal Revenue Code changes and the 1990 proposed regulations.

The content of the proposed regulations in so far as they relate to exchanges of real estate are examined in detail. Examples of determination of gain and of basis of replacement property

are provided. In the final section the meaning of certain basic concepts such as "held for productive use in a trade or business or for investment" and "like-kind" property are examined.

Definition of Deferred Like-Kind Exchanges

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

There are certain requirements in respect to identification and receipt of replacement property which must be satisfied. Otherwise the replacement property will not be considered of like-kind to the relinquished property and the nonrecognition of gain or loss rules will not apply.

In order to constitute a deferred exchange, the transaction must be an exchange. For example a transfer of property for property is distinguished from a transfer of property for money. A sale of property followed by a purchase of property of a like- kind does not qualify for nonrecognition of gain or loss under section 1031 regardless of whether the identification and receipt requirements are satisfied.

Evolution of Deferred Exchange Rules

Section 1031(a)(3) enacted by the Tax Reform Act of 1984 is the basic statute which deals with the required qualifications of delayed exchanges which qualify for tax deferral. Prior to its enactment, taxpayers looked for guidance to a decision in T.J. Starker v. U.S., 602 F.2d 1341 (1979).

The Starker Case

In the Starker case, the taxpayer entered into an agreement with the Crown Zellerbach Corporation to exchange land owned by Starker in return for Crown's promise to secure for the taxpayer other real property to be chosen by him. The agreement gave the taxpayer five years in which to locate suitable replacement property, and to the extent that the replacement value was less than the value transferred by Starker, the balance was to be paid out in cash to Starker. In addition, the taxpayer was credited with a six per cent increase on the outstanding balance for the growth of timber located on the original property. The IRS contested Starker's claim for nonrecognition under Section 1031 on the grounds, among others, that the exchange was not simultaneous.

The court held that simultaneity was not required under Section 1031 and that the current transfer of property for a promise of a future transfer of like-kind property constituted a valid deferred exchange. This outcome was apparently not affected by the fact that Starker could potentially receive cash instead of like-kind property in the exchange. The six percent increase on the outstanding balance, however, was found to be includable interest since its payment was not tied to the actual value of the growing timber.

Tax Reform Act of 1984

In an effort to prevent abuses Congress amended Section 1031 to include the present time restrictions on deferred exchanges.[Section 1031 (a)(3)] The amendment specified time requirements for both identification and receipt of property.

A taxpayer has forty-five days after he transfers the property to the buyer or intermediary to identify the property. In addition, the target property must be obtained by the taxpayer within the earlier of 180 days after the original property is relinquished or the due date, including

extensions, of his tax return for the taxable year in which the original property was disposed of. Both the identification and the receipt time periods must be observed in order to qualify for tax deferral. The 1984 Act also eliminated the like-kind rules for exchanges of partnership interests.

1989 Act-Related Parties

If property received in a like-kind exchange between related persons is disposed of within 2 years after the date of the last transfer that was part of the like-kind exchange, the original exchange will not qualify for nonrecognition of gain or loss under Sec.1031. Any gain or loss that was not recognized on the original exchange must be recognized as of the date that the property is disposed of. This rule will not be applied if it is established to the IRS's satisfaction that neither the exchange nor the subsequent disposition had as one of its principal purposes the avoidance of federal income tax.

1989 Act-Foreign Property

The nonrecognition rule does not apply if one of the exchanged properties consists of real property located outside the United States. Real property located in the United States and real property located outside the United States are not like-kind property [Sec.1031 (h)45 day] 1990.

Proposed Regulations

The new regulations provide important guidance for deferred like-kind exchanges. (1) Special rules are established for the identification and receipt of replacement property. (2) The number of alternative properties that may be identified are limited in number and value. (3) The actual or constructive receipt of cash as an intermediate step in the exchange is prohibited. Four "safe harbor" rules are established to avoid such receipt. These rules provide for increased certainty in tax planning.

Identification and Receipt Requirements

The new regulations continue the previous time requirements. Both the 45-day identification period and the 180-day replacement period described above must be met to obtain tax free exchange treatment.

If the taxpayer transfers more than one relinquished property and the properties are transferred on different dates, the identification period and the exchange period are determined by reference to the earliest date on which any of such properties are transferred.

Example of Application of Identification Rule

Facts:

M Corp, a calendar year taxpayer enters into an agreement for an exchange of property X to C corporation.

M Corp is required to identify like-kind replacement property which C is required to purchase and to transfer to M.

M transfers property X to C on November 17, 1990.

The identification period ends on January 1, 1991. This is the day which is 45 days after the date of transfer of property X, even though it is New Year's day. The exchange period ends on March 15, 1991 which is the due date for M Corps federal income tax return. However, if M is allowed the automatic six-month extension for filing its tax return, the exchange period ends on May 16, 1991. This is the day which is 180 days after the date of transfer of property X.

Identifying Replacement Property.

Any replacement property that is received by the taxpayer before the end of the identification period will in all events be treated as identified before the end of the identification period.

There are other methods of satisfying the identification requirements. The replacement property is 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 a person involved in the exchange other than the taxpayer or a related party. Related parties include the seller's agent such as an attorney, employee or broker.

The replacement property may also be identified in a written exchange agreement signed by all the parties involved. This must be done before the end of the identification period and is effective regardless of whether the agreement is sent to a person involved in the exchange.

Alternative and Multiple Properties

There is a limit on the number of replacement properties that the taxpayer may identify regardless of how many properties are relinquished.

There are two rules. These are the "three property rule" and the "200 percent rule."

Three Property Rule: Three properties may be identified regardless of their market value.

200 Percent Rule: Any number of properties may be identified as long as their aggregate fair market value as of the end of the identification period does not exceed 200 percent of the aggregate fair market value of all the relinquished properties as of the date the relinquished properties were transferred by the buyer.

If a taxpayer identifies more property than allowed he is treated as if no property has been timely identified. This rule will not apply to any replacement property received by the taxpayer

before the end of the identification period. It will also not apply to any replacement property identified before the end of the identification period and received before the end of the exchange period, but only if the taxpayer receives identified replacement property constituting at least 95 percent of the aggregate fair market value of all identified replacement properties before the end of the exchange period.

Incidental Property Disregarded

For purposes of determining the number of properties any property that is incidental to a larger item of property is not treated as property that is separate from the larger item of property under certain circumstances. Property is incidental to larger items of property if in standard commercial transactions, the property is typically transferred together with the larger item of property, and the aggregate fair market value of all such property does not exceed 15 percent of the aggregate fair market value of the larger item of property.

For example furniture, laundry machines, and other miscellaneous items of personal property will not be treated as separate property from an apartment building with a fair market value of $1,000,000 if the aggregate fair market value of the furniture, laundry machines, and other personal property does not exceed $150,000.

Revocation of Identification

An identification of property as replacement property may be revoked at any time before the end of the identification period. The revocation must be in writing and be signed by the taxpayer and sent before the end of the identification period to the same person addressed in the original identification period.

Examples

Basic Facts For Following Examples

Margaret, a calendar year taxpayer, enters into an agreement with George to enter into a deferred exchange. Margaret transfers her condo to George on May 17, 1991.

Margaret's condo was held for investment,is unencumbered and has a fair market value on May 17, 1991 of $100,000. On or before July 1, 1991(end of identification period) Margaret is required to identify replacement property that is of a like-kind to her condo. On or before November 13, 1991 (the end of the exchange period), George is required to purchase the property identified by Margaret and to transfer that property to Margaret. To the extent the fair market value of the replacement property transferred to Margaret is greater or less than the fair market value of the condo, either Margaret or George as applicable will make up the difference by paying cash to the other party after the date the replacement property is received by Margaret. The replacement property is described by legal description and is of a like kind to the Condo. Margaret intends to hold the replacement property received for investment.

Example 1

On July 2, 1991, Margaret identifies a duplex as replacement property. She designates the duplex as replacement property in a written document she signs and personally delivers to George.

Margaret loses the benefit of the deferral of gain under the like-kind rules because the identification was made after the end of the identification period.

Example 2

On June 3, 1991, Margaret identifies the replacement property as "unimproved land located in Hood County with a fair market value not to exceed $100,000." The designation is

made in a written document signed by Margaret and personally delivered to George. On July 8, 1991, Margaret and George agree that real property H is the property described in the June 3, 1991 document.

Margaret loses the benefit of the like-kind rules because the real property H was not unambiguously described before the end of the identification period.

Example 3

On May 17, 1991, Margaret identified real properties M,N,P, and Q as replacement properties by designating such properties as replacement properties in a written document she signs and personally delivers to George. The written document provides that by July 2, 1991, the fair market values of real properties, M,N,P, and Q are $30,000, $40,000, $50,000 and $60,000 respectively.

The 3 property rule is violated but Margaret is saved by the 200 percent rule. Although she identified more than 3 properties as replacement properties, the aggregate fair market value of the identified properties as of the end of the identification period did not exceed 200 percent of the aggregate fair market value of her condo. Recall the fair market value of her condo was $100,000. The aggregate value of the replacement properties is $180,000.

Produced Replacement Property

A transfer of relinquished property in a deferred exchange will not fail to qualify for nonrecognition of gain or loss under section 1031 merely because the replacement property isn't in existence or is being produced at the time the property is identified as replacement property.

A transfer of property for services (including production services) doesn't qualify. Any additional production occurring with respect the replacement property after the property is received by the taxpayer will not be treated as the receipt of a property of a like-kind.

Assume property is constructed for the seller and the building is not completed within the 180 days maximum exchange period. The cost of the land and the completed construction during the 180 day exchange period qualifies for like-kind treatment. The construction materials purchased but not yet part of the building as of the 180th day does not qualify. Construction completed after the 180th days does not qualify as like-kind.

Avoidance of Cash Receipt

Deferred exchanges have been in danger of losing their nonrecognition of gain status if a seller is considered to have constructive receipt of cash or other nonlike-kind property. This creates a problem for the seller of property because she does not want to be in the position of transferring property until she has adequate security that the buyer will purchase the exchange property. If the taxpayer actually or constructively receives money or property which does not meet the requirements of section 1031(a) in the full amount of the consideration for the relinquished property, the transaction will constitute a sale, and not a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property.

Constructive Receipt

Constructive receipt is defined in Regulation 1.1031(a)-3 as follows: Income, although not actually reduced to the taxpayer's possession, is constructively received by him in the taxable year in which it is credited to his account, set apart for him or otherwise made available so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

The taxpayer is in constructive receipt of such money or property at the time such limitations or restrictions lapse, expire, or are waived. In addition, actual or constructive receipt

of money or property by an agent of the taxpayer is actual or constructive receipt by the taxpayer.

1990 Regulations Establish Safe Harbors

The 1990 regulations provide four "safe harbor" rules which allow the taxpayer to avoid constructive receipt. However, even if a transaction is within the safe harbors, to the extent the taxpayer has the ability or unrestricted right to receive money or other property before the taxpayer actually received like-kind replacement property, the transfer of the relinquished property will not qualify for nonrecognition of gain or loss under section 1031(a).

Effective Date

The proposed regulations will be effective for transfers of property made after July 2, 1990. The new rules do not apply to an exchange made under a written binding contract that was in effect on May 16, 1990, and which is binding at all times thereafter.

Guarantee Arrangements

The first safe harbor involves security or guarantee arrangements. The seller can be protected by having the buyer's obligation to transfer the replacement property secured or guaranteed by one or more of the following: (1) a mortgage, deed of trust, or other security in property but not by cash or a cash equivalent; (2) a nonnegotiable, nontransferable standby letter of credit issued by a financial institution that does not allow the seller to draw on this letter except upon default by the buyers; (3) A third-party guarantee.

Qualified Escrow Accounts and Qualified Trusts

The buyer's obligation to transfer replacement property may be secured by cash or cash equivalents if it is held in a qualified escrow account or trust. The escrow holder cannot be the taxpayer or a related party.

The taxpayers cannot have the right to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in the escrow account until one of the following circumstances occurs: (1) The identification period expires and no replacement property is timely identified; (2) The seller has received the identified property; (3) The exchange period has expired.

The escrow or trust is considered to be qualified in the case where the seller has identified property if he or she cannot obtain the benefits of cash until the later of either (1) or (2) as follows: (1) the end of the identification period; (2) the occurrence of a material and substantial contingency relating to the deferred exchange. This contingency must be provided for in writing and be beyond the control of the seller or a related party.

The important lesson is that the seller cannot have the ability to receive cash or cash equivalents. Tax planning requires extreme care to ensure that the seller's right to receive cash is restricted to those circumstances specified in the regulations.

Example

The proposed regulations provide examples of when the right to cash does and does not disqualify a like-kind exchange. The following situation would not disqualify the exchange. Facts: The facts are the same as the previous examples except for the following addition. Margaret transfers her condo to George on May 17 and George deposits $100,000 in escrow as security for his obligation to perform under the agreement. The escrow agreement provides as

follows: The funds in escrow are to be used to purchase the replacement property. If Margaret fails to identify replacement property on or before July 1, 1991, Margaret may demand the funds in escrow at any time after July 1, 1991. If Margaret identifies and receives replacement property, then Margaret may demand the balance of the remaining funds in escrow at any time after Margaret has received the replacement property. Otherwise, Margaret is entitled to all funds in escrow after November 13, 1991. The escrow holder is not a related party. Margaret identifies replacement property and George purchases the replacement property using the funds in escrow and transfers the replacement property to Margaret.

Margaret is determined not to be in actual or constructive receipt of the $100,000 held in escrow before she received the like-kind replacement property. Margaret did not have the ability or unrestricted right to the money before Margaret actually received the like-kind replacement property.

Qualified Intermediary

Another safe harbor involves the use of a qualified intermediary. The intermediary cannot be the seller or a related party. The intermediary facilitates the exchange by doing the following: (1) Agrees to acquire the seller's property; (2) Acquires replacement property; (3) Transfers the replacement property to the seller.

Example of Like-Kind Exchange Using an Intermediary

Facts:

-Margaret wishes to sell her condo held for investment but wishes to maintain a real estate investment and would exchange for like-kind property

-She would like to avoid current taxable recognition of gain. -Henry would like to buy Margaret's condo and is willing to cooperate in a like-kind exchange.

-Lawyer Jones is engaged as an intermediary.

-Margaret transfers her condo to Lawyer Jones who sells it to Henry.

-Lawyer Jones purchases qualifying like-kind property identified by Margaret from a third party and transfers it to Margaret.

Restrictions on the Intermediary

The intermediary may not be a party related to the seller. A person that qualifies as the seller's agent only because of services performed involving the exchange is not considered a related party. The use of an intermediary for an exchange will not be disqualified solely because the intermediary acted as the seller's intermediary in previous exchange transactions.

The sellers right to receive money from the intermediary are subject to the same restrictions that are discussed above involving qualified escrow accounts and trusts.

Interest and Growth Factors

A taxpayer is entitled to receive interest or growth factor with respect to a deferred exchange if the amount of money or property the taxpayer is entitled to receive depends upon the length of time elapsed between transfer of the relinquished property and receipt of the replacement property.

The interest or growth factor is treated as interest, regardless of whether it is paid to the taxpayer in cash or in property. The taxpayer must include such interest or growth factor in income according to the taxpayer's method of accounting.

Determination of Recognized Gain or Loss in Deferred Exchange

If a taxpayer receives cash or other non qualifying property in a like-kind exchange gain will be recognized. The amount of gain recognized is determined under the rules of section 1031

and the regulations thereunder. A taxpayer must also determine the basis of replacement property for the purposes of determining deprecation and for determination of future gain or loss on sale or exchange of the replacement property.

Examples Illustrating Determination of Gain or Loss and Basis

Facts: The following facts will be assumed in the examples below:

Margaret, a calendar year taxpayer, and George agree to enter into a deferred exchange. Margaret transfers her condo to George on May 17, 1991. Margaret has held her condo for investment. It is unencumbered and has a fair market value on May 17, 1991 of $100,000 Margaret's adjusted basis in the property is $40,000.

A duplex is timely identified as replacement property and is replaced timely as required. The replacement property is considered to be of a like-kind to Margaret's condo. Margaret intends to hold the duplex for investment.

Example 1

In addition to the above, George transfers $10,000 to Margaret on September 4, 1991. George purchases the duplex for $90,000 and transfers it to Margaret.

The $10,000 is considered to be "money or other property" for purposes of section 1031 and the regulations thereunder. As a result Margaret recognizes gain in the amount of $10,000. Note Margaret's realized gain is $60,000 but only $10,000 is recognized. Her realized gain is determined by subtracting from the amount realized ($100,000) the adjusted basis of the property ($40,000). The amount realized is the sum of the $10,000 cash and the fair market value of the duplex of $90,000.

Margaret has a basis for her duplex of $40,000 as determined below:

Basis in condo $40,000

Less Money received (10,000)

Plus Gain recognized 10,000

Adjusted basis in duplex $40,000

Example 2

Facts: Assume basic case facts with following additions:

George transfers $10,000 to Margaret on May 17, 1991. On September 4, 1991 George purchases a duplex for $100,000 and transfers it to Margaret. On the same day Margaret transfers $10,000 to George.

The $10,000 Margaret received on May 17 is considered "money or other property" for purposes of section 1031 and the regulations thereunder. Therefore Margaret recognizes gain in the amount of $10,000 [IRC 1031(b)].

The basis of the duplex for Margaret is $50,000

Basis of condo $40,000

Less money received (10,000)

Plus gain recognized 10,000

Additional consideration 10,000

Basis $50,000

Example 3

Facts: Assume facts of basic case

Margaret has the right at all times to demand $100,000 in cash in lieu of replacement property.

Because Margaret has the right to demand $100,000 in cash in lieu of the replacement property she is considered to be in constructive receipt of $100,000. As a result she loses the benefits of the deferral of gain under section 1031 and must recognize gain of $60,000. This is the amount realized of $100,000 less adjusted basis of $40,000. Her basis for the duplex is $100,000.

Example 4

Facts: Assume facts of basic case.

Margaret's condo is encumbered by a mortgage of $30,000.

On May 17, 1991 Margaret transfers her condo to George.

George assumes the $30,000 mortgage on the condo. The replacement duplex is encumbered by a $20,000 mortgage. On July 5, 1991 George purchases the duplex for $90,000 by paying $70,000 and assuming the mortgage. The duplex is transferred to Margaret and Margaret assumes the mortgage on the duplex.

The excess of the liability assumed by George ($30,000) is offset by the mortgage assumed by Margaret ($20,000) and the $10,000 difference is considered "money or other property" received by Margaret [Reg. 1.1031(b)-1(c)] Thus Margaret recognizes a gain of $10,000 [IRC 1031 (b)].

Margaret's basis in the replacement duplex is $40,000

Adjusted basis in condo $40,000

Less mortgage relieved ($30,000)

Plus mortgage assumed $20,000

Plus gain recognized $10,000

Basis of duplex $40,000

Margaret is considered as having received money in the form of the liability assumed by George. She is assumed to have paid money in the form of the liability she has assumed.

Basic Concepts

This section reviews the basic concepts under Section 1031 of the Internal Revenue Code. It also provides examples of determination of gain when money or other property is received in an otherwise non-taxable exchange. Examples of determination of basis of replacement property are also provided.

Provisions

IRC Section 1031, as amended in 1984, provides in part that: 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.

Thus, Section 1031 provides an exception to the general rule that realized gains must be recognized in the year of realization. Application of section 1031 is mandatory when its requirements are met and does not allow for a taxpayer election.

Productive Use in a Trade or Business or Held for Investment

Neither the Code nor the Regulations expressly defines the term; however, the "for productive use in a trade or business or for investment" requirement has been held to be satisfied by the absence of an intent on the part of the taxpayer to either liquidate the investment or use the property for personal purposes (Bolker v. C.I.R., 760 F.2d 1039 (1985).

Neither 1031 nor its accompanying regulations directly outline what constitutes trade or business property. However, in Revenue Ruling 59-229,1952 CB 180, the Service relied on Section 1231(b) in interpreting trade or business property. According to Section 1231(b), which

covers the definition of property used in a trade or business: The term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more that 6 months, and real property used in the trade or business, held for more than 6 months, which is not-

(A) property of a kind which would properly be includable in the inventory of the taxpayer if on hand at the close of the taxable year,

(B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business...

Thus, "property used in a trade or business" includes real property used in a trade or business and/or for sale, if it is not held primarily for sale to customers in the ordinary course of business. Also included is property acquired for use in a trade or business even if it is never used in the business (Rev.Rul.58-133,1958).

Usually, rental real property is property used in a trade or business under Section 1231. However, whether real property is "held primarily for sale to customers in the ordinary course of business" or is "used in a trade or business" is a question of fact to be determined on a case by case basis. The controlling factor is the purpose for which property is held at the time of sale. Thus, for example, property which may have previously been held for sale may be converted to rental property, and thus become trade or business use property, before its sale. Other factors include reasons for the acquisition and disposition of the property, the type of property involved, and the extent of the taxpayer's selling activities.

Courts have included all uses necessary for "commerce and industry "within the ambit of "productive use in business." Thus, in National Outdoor Advertising Bureau, Inc. v. Commissioner [32 BTA 1025,aff'd 89 F2d 878 (2d Cir. 1937)], cars used to inspect potential billboard locations were productive business use property.

As for the "investment" part of the requirement, regulation 1.1031(a)-1(b) provides that property held by one other than a dealer for "future use or future realization of the increment in value" is held for investment. Dealers in real estate must be particularly cautious with investments since the burden is on them to prove that property acquired for investment purposes is held separately from those held primarily for sale. (Land Dynamics v. Commissioner, 37 TCM 1119, 1978).

Section 1031 explicitly excludes certain types of property from its coverage. Excluded are stock in trade or other property held primarily for sale, stock, bonds, notes, or other securities, interests in a partnership, certificates of trust, choses in action, evidences of indebtedness, and interest. Therefore, the exchange of inventory items is not covered, and neither is the exchange or transfer of one's right of action against another party. Other examples of nonqualifying exchanges include a swap of a real estate mortgage for farm loan bonds or a transfer of treasury bonds with different maturity dates [Reg.1.1031(a)-1(d)].

On the other hand, unproductive real estate held by a dealer for its potential appreciation or future development does qualify, as would exchanges of professional sports contracts.

The Code does not give a specific time period for which either the property relinquished or the replacement property must be held in order to satisfy the holding requirement. While this omission resulted in some uncertainty in the past, the significance of the holding requirement has probably been considerably abrogated by decisions such as Bolker, which concluded that a taxpayer satisfies the requirement by owning the property given up or by acquiring the exchange property with the intent to exchange it for like-kind property. Some revenue rulings had previously held that a taxpayer who purchased property for the express purpose of facilitating an exchange did not qualify for gain deferral since he had never held the property for use in a trade or business or for purposes of investment.

Meaning of Like-Kind

The regulations provide that the words "like-kind" have reference to the nature or character of the property and not to its grade of quality" [Reg. 1.1031(a)-1(b)]. Thus, for example, the fact that an improved lot is exchanged for an unimproved lot is by itself immaterial since the condition of improvement pertains only to the grade of quality of the property and not to the character of class of it. But, property of one class may not be exchanged under the section for property of a different class or kind. For example real property may not be exchanged for personal property, since the two are of a different nature and character. The Code itself provides but little guidance in the determination of what constitutes "like-kind" by establishing that livestock of different sexes are not property of a like-kind for purposes of Section 1031 [1031(e)].

In general, the various regulations, rulings, and cases provide much less authority or direction for the determination of the sorts of personal property which would qualify as like-kind than for real property. The exchange of an old truck used in a trade or business for a new one for the same use constitutes a like-kind exchange [Reg. 1.1031(a)-1(c)(1)]. And, it has been held that the exchange of gold bullion held for investment for silver bullion also held for investment was not like-kind since "silver and gold are intrinsically different metals and primarily are used in different ways" [Rev.rul. 82-166, 1982-2 C.B. 190]. Also settled is the fact that property held for productive use may be exchanged for property held for investment [Reg. 1.1031(a)-1(a)].

Unlike the case with personal property, the range of the types of real estate which qualify as like-kind is very broad. Some examples of permissible real property swaps include:

-transfer of mineral rights for a hotel qualified although a limited right to extract minerals from one piece of land for land will not qualify.(Clemente, Inc., TCM 1985-367)

- farm land for rental real estate in a city (Braley, 14 BTA 1153(1929),acq. VII-2 C.B.6.)

-leasehold interest in a producing oil lease for a ranch (Rev.Rul. 68-331); and

-a commercial building for an unimproved lot [Burkhard Investment Co., V. U.S. 100 F.2d 642 (9th Cir.0 (1939).

Conclusion

The proposed regulations for section 1031 promulgated in 1990 provide needed guidance in the planning of deferred like kind exchanges. Safe harbors are provided so that transactions may be structured without many of the uncertainties which previously concerned many taxpayers.

Time constraints on the identification and on the replacement of property must be carefully adhered to. Methods of identifying property are specified as are limits on the number and fair market value of identified property. In certain situations property that is being constructed may qualify as replacement property.

Constructive receipt problems in the past sometimes caused the loss of the benefits of section 1031. Four safe harbors are provided in the regulations under which taxpayers will not be considered in actual or constructive receipt of money or other non like-kind property. Careful following of these safe harbors is essential.

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