

CHICAGO DEFERRED EXCHANGE COMPANY

DEFERRED EXCHANGE REGULATIONS

It is interesting to reflect for a moment on the changes in the administration of the nation's tax policy over the last several years. When the Treasury Department issued Regulations designed to implement changes affecting investment in real estate by the 1986 Tax Reform Act, they were severely criticized for drafting Regulations which were extremely technical and complex. For example, the Regulations defining "passive activities" are so complex that they may be, in many cases, disregarded by practitioners frustrated by their complexity. Thus, regulatory activity intended to increase compliance with the tax laws, may have had the opposite effect.

Stung by public criticism, the Internal Revenue Service under then Commissioner Fred T. Goldberg, began publicly to adopt the theme of simplification in Regulation projects underway in the late 80's. Examples of this change in philosophy are both the Final Regulations on Multi-Asset Exchanges and Exchanges of Personal Property, issued in March, 1991, and the Final Regulations on Deferred Exchanges and the Inapplicability of Section 1031 to Exchanges of Interests in Partnerships, issued in May, 1991. Both of these Regulations provide "bright line" tests, or "safe harbors" which give most Taxpayers clear rules for determining the income tax consequences of various transactions, rather than attempting to anticipate and answer every conceivable potential variation.

The Multi-Asset Regulations provide two tests for determining when depreciable, tangible personal property will be considered like-kind. The first test utilizes Revenue Procedure 87-56. The second test utilizes product classes ("SIC Codes") as published in the Standard Industrial Classification Manual. Using these Regulations, most Taxpayers will be able to determine with certainty what types of personal property will be considered like-kind under Section 1031.

The Deferred Exchange Regulations likewise provide Taxpayers with "safe harbors" which may be employed in structuring and securing both simultaneous and delayed tax deferred exchanges. My purpose in what follows is to provide assistance in navigating the narrow channels created by the Regulations through hazardous waters. The importance of staying within the channels is more critical today than prior to the issuance of regulatory guidance when a smattering of case law and a limited number of public rulings were the only channel markers. In the words of the Barker Court, **"At some point, the confluence of some sufficient number of deviations will bring about a taxable result."** The very existence of the safe harbors and bright line tests in the Regulations create a burden on tax practitioners to make every effort to structure exchanges within these guidelines, where the tax risk of the transaction can be minimized. Failure to meet the technical requirements of the safe harbors is likely to generate a number of malpractice claims in the future. The Regulations provide practitioners with clear channels to safe harbors, but the sides of these

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channels are strewn with the potential to wreck. Stay inside the channels, and you will dispose, sometimes magically, of the issues of agency, constructive receipt, the like-kind standard, and the exchange requirement. Venture outside the channels, and you invite disaster.

IRC Section 7805: Interpretive Regulations: One important aspect of the Multi-Asset Regulations and the Deferred Exchange Regulations is that they are published under the general interpretative authority of Section 7805 of the Internal Revenue Code. These Regulations do not have the force of law but it is likely that they will receive considerable deference in the courts. To the extent that auditing agents can understand the Regulations, they will apply them as if they were holy writ. Structurally, the final Regulations are organized into both substantive rules and safe harbors. The substantive rules reflect the Treasury Department's interpretation of the requirements of Section 1031, although in fact they go well beyond the specific language of the statute. Most of the remainder of the Regulations is devoted to safe harbors. Practically speaking, auditing agents will probably disallow exchanges which do not meet the requirements of the safe harbors and leave the issues for resolution at the appellate conference. In fact, at the time of this writing, auditing agents are recommending exchange transactions for litigation by the Government where strict observance of the Regulations is not apparent.

