

CHICAGO DEFERRED EXCHANGE COMPANY

OTHER NON-TAXABLE EXCHANGES UNDER IRC SECTIONS 1032 – 1042

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Section 1032 Exchange of Stock for Property: Gain or loss is not recognized to a corporation that received money or other property in exchange for its stock, including treasury stock. Where a corporation received its own stock, §1032 does not apply unless the receipt of the stock is in exchange for other stock of the corporation. No gain or loss will be recognized to a corporation on the lapse or acquisition of an option to buy or sell its stock (including treasury stock). This rule applies to options acquired or lapsed after July 18, 1984. The basis of such property acquired by a corporation in an exchange is determined by IRC §362 and the Regulations thereunder.

Section 1033 Involuntary Conversions: IRC §1033 was enacted to prevent a Taxpayer from being taxed on profits from an involuntary disposition of property. An involuntary conversion occurs when a Taxpayer's property (i.e. real estate or livestock) is destroyed by casualty, stolen or is requisitioned or condemned for public use. The length of time allowed to replace the involuntarily converted property depends both on the character of the property converted (real v. personal) and the cause of the conversion (destruction or theft v. condemnation). In general, it is two (2) years after the close of the first taxable year in which any part of the gain on the conversion is realized. The two (2) year period is extended for an additional one (1) year in the case of real property converted as a result of condemnations or other seizures, provided the property was business (non-inventory) or investment real property.

The "like-kind" test currently applicable under IRC §1031, applies where a loss is incurred with respect to real property which was lost through condemnation. However, there are exceptions, specifically where, instead of replacing the condemned property, the Taxpayer (1) acquired control of a corporation that owns like-kind property, or (2) replaces real estate held as stock in trade or primarily for sale. If either of these situations exists, then the "similar use" rules apply.

Under the "similar use" rule, gain from involuntary conversions will not be recognized where the converted property is replaced with property that is "similar or related in service or use" to the converted property.

The Case Law Under IRC Section 1033 Demonstrates Substantial Uncertainty in the Application of the "Similar or Related in Service or Use" Test

A. Six Circuits and the Internal Revenue Service have developed four different standards for application of the similar-use test to an owner-lessor.

1. The Second, Sixth, and Seventh Circuits, as well as the IRS (Rev. Rul. 64-237) apply the Liant test: "a court must compare, *inter alia*, the extent and type of the lessor's management activity, the amount and kind of services rendered by him to the tenants, and the nature of his business risks connected with the properties." Liant 9 AFTR 2d 1557, 1560 (2d Cir. 1962). The Service and the courts have diverged in their application of this standard.

2. Eighth Circuit (Loco Realty 10 AFTR 2d 5359, 5366 (8th Cir. 1962)): "It is sufficient if, coupled with the leasehold characteristics of the Taxpayer's properties; there is also a reasonable similarity in the leased premises themselves." This standard does not seem to have been applied in any subsequent cases.

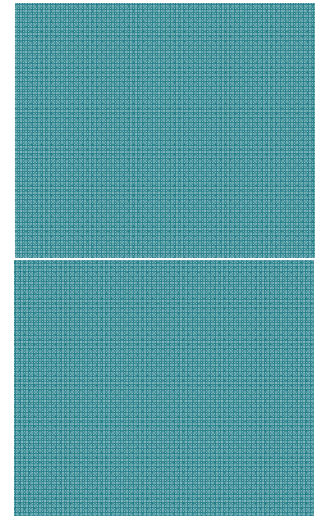
3. Ninth Circuit (Filippini 11 AFTR 2d 1720, 1722 (9th Cir. 1963)): "The test is a practical one. The trier of fact must determine from all the circumstances whether the Taxpayer has achieved a sufficient continuity of investment to justify non-recognition of the gain, or whether the differences in the relationship of the Taxpayer to the two investments are such as to compel the conclusion that he has taken advantage of the condemnation to alter the nature of his investment for his own purposes."

The Filippini court specified a list of factors that should be considered in making the determination:

The broad range of the appropriate inquiry is suggested by Liant's enumeration of relevant factors as including "the extent and type of the lessor's management activity, the amount and kinds of services rendered by him to the tenants, and the nature of his business risks connected with the properties." Since the essential inquiry is whether the Taxpayer has committed the condemnation award to a substantially equivalent investment, the relevant facts include all those which would influence an investor in determining the attractiveness of the respective uses for his capital; the character and location of the particular properties, their potential and actual employment, the state of the market of which each is a part. As Liant suggests and Clifton Investment emphasizes, the relevant facts also include the demands which the respective investments may make upon the Taxpayer for supervision and service.

11 AFTR 2d at 1722 (citations omitted).

Fourth Circuit (Steuart Bros., 3 AFTR 2d 318 (3rd Cir. 1958)): This is the first case making the owner-user/owner-lessor distinction. Steuart does not clearly articulate limitations on the similarity of real property held for rental income. Some later cases understand Steuart to hold that all rental properties are similar; other cases interpret Steuart as employing a "same general class test." See Part B(1) *infra*.



B. The Loco Realty and Steuart tests are themselves unclear.

1. Steuart Bros., 3 AFTR 2d 318 (3rd Cir. 1958).

Steuart was the first case drawing an owner-user/owner-user lessor distinction, and its statement of the law is ambiguous as to whether all rental properties are of similar use or whether the properties must be in the "same general class." In Loco Realty, 10 AFTR 2d 5359, 5365 (8th Cir. 1962), the court noted the ambiguity in Steuart equally broadly. On the other hand, McCaffrey, 5 AFTR 2d 774 (3rd Cir. 1960), which is the only circuit to apply the functional use test to an owner-lessor (a position the Service rejected in 1964), understood Steuart as creating the "same general class" test. The district court in Filippini, 9 AFTR 2d 313 (N.D. Ca. 1971), aff'd 11 AFTR 2d 1720 (9th Cir. 1963), reached the same conclusion. (The Ninth Circuit rejected the "same general class" test.)

The Pohn court, 10 AFTR 2d 5780, 5782 (7th Cir. 1962), reviewed the overall situation in 1962, before Filippini added yet another test, as follows: "There is a basic difference of opinion between the Third and the Second, Fourth and Eighth Circuits, and among the latter three there are shades of difference in the test applied."

2. Loco Realty, 10 AFTR 2d 5359 (8th Cir. 1962).

Loco Realty's requirement of "reasonable similarity of the leased premises" has been subject to different interpretations by two courts that have cited it. In Pohn, the court interpreted the Loco Realty test as more restrictive than the Second Circuit's Liant test, asserting that "the [Loco Realty] court avoided the extreme statement of the Steuart and Liant doctrine that both properties need only qualify as investments." However, the concurring opinion in Clifton Investment Co., 11 AFTR 2d 649, 651 (6th Cir. 1963), construed Loco Realty as more liberal than Liant. In his concurrence, Judge Miller wrote:

I think that the investment character of the properties involved should be given more consideration than what seems to me is given by the ruling in the Liant case, although I do not think that investment basis alone is sufficient to comply with the statute, as Steuart Brothers, Inc. v. Commissioner might be construed as holding. As pointed out in Loco Realty Co. v. Commissioner, the statute was not intended to penalize but to protect persons whose property may be taken on condemnation and, accordingly, should be construed liberally. I agree with the standard adopted in the opinion in that case, although for our present purposes I do not think that it results in a reversal of the decision of the Tax Court.

Id. at 651 (citations omitted).

Judge Miller cites Loco Realty here as more liberal than the Liant test, in direct contradiction with the Pohn court.

C. A crucial issue regarding the similar use test remains undecided.

Unlike the functional use test applied to an owner-user, which looks to the property's physical characteristics and end uses, the Service, following Liant, applies a management activity test to an owner-lessor. As long as both properties are used by the Taxpayer for rental income, the properties are of similar use if they demand from the Taxpayer the same amount and kind of management activity, services and relations to tenants, and give rise to the same business risks. This test seems to completely disregard the physical characteristics of the properties. Indeed, Johnson 43 T.C. 736 (1965), permitted the replacement of improved farmland leased to a riding club with urban land leased to a gas station.

In conflict with this line of reasoning, a number of courts seem to have understood that Reg. Section 1.1033(a)-2(c)(9)(i) applies to prevent even an owner-lessor from replacing unimproved with improved realty. These cases imply that similar use requires similar physical characteristics even for an owner-lessor. The unresolved question is the extent to which the character of the property is relevant in the case of a replacement by an owner-lessor.

D. The Filippini test provides for case-by-case decision making by lower courts, ensuring a substantial increase in litigation if this proposal is enacted.

The Filippini test examines "all the circumstances" to reach an overall sense of whether the Taxpayer has maintained continuity of investment. The Filippini court expressly rejected any more definite standard. Any test consisting of a broad survey of the circumstances is likely to be an overwhelmingly fact-based exercise. However, the Filippini court went even further, when in n. 4, it cited *Duberstein*, 363 U.S. 278, 279 (1960):

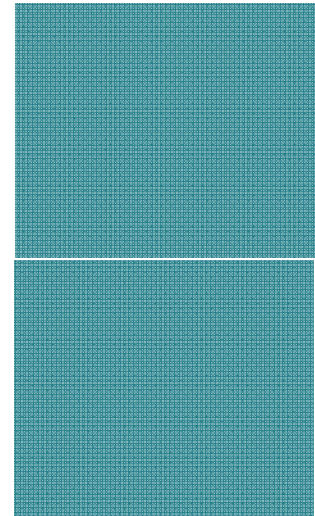
Decision of the issue presented in these cases must be based ultimately on the application of the fact-finding tribunal's experience with the mainsprings of human conduct to the totality of the facts of each case. The non-technical nature of the statutory standard, the close relationship of it to the data of practical human experience, and the multiplicity of relevant factual elements, with their various combinations, creating the necessity of ascribing the proper force to each, confirm us in our conclusion that primary weight in this area must be given to the conclusions of the trier of fact.

The court thus expressed its conclusion that the similar use test is not the kind of legal standard that allows appellate courts to clearly guide the lower courts. Instead, each case is different, with the lower courts applying their experience "with the mainsprings of human conduct to the totality of the case." This delegation to the lower courts will substantially increase litigation if applied in the context of like-kind exchanges.

Section 1034 Rollover of Gain on Sale of Principal Residence (Repealed by Taxpayer Relief Act 1997): Gain realized from the sale of a personal residence can be deferred if the Taxpayer purchases or constructs a replacement home within a specified period. This non-recognition is mandatory. For Taxpayers who are 55 or older at the time the personal residence was sold, IRC §121 provides special exclusion-of-gain rules that may be used in conjunction with IRC §1034.

Section 1035 Certain Exchanges of Insurance Policies: Insurance, endowment and annuity policies are "property" so that gain or loss on an exchange of such policies ordinarily would be recognized for tax purposes with §1035. Section 1035 sets out three (3) categories in which no gain or loss be recognized on the exchange of:

1. a life insurance contract for another life insurance contract or for an endowment or annuity contract;
2. an endowment contract for certain other endowment contracts (as listed in IRC §1035 and the Regulations thereunder) or for an annuity contract;
3. an annuity contract for another annuity contract.



Exchanges not falling within the above three (3) categories are taxable exchanges. If a life insurance policy provides the policy holder with an option to change the insured, exercise of the option is treated as a sale or other disposition of the policy and is not eligible for non-recognition treatment.

Where one of the tax-free exchanges listed above occurs, the new policy received by the Taxpayer will take a basis of the contract exchanged for it. Therefore, where the exchange involves contracts the proceeds of which are taxable (such as an annuity), any gain on the original contract which is not recognized at the time of the exchange will be taxed when the proceeds of the second contract are realized.

Section 1036 Stock for Stock of Same Corporation: An exchange (whether or not a corporation reorganization) of common stock for common stock in the same corporation, or of preferred stock for preferred stock in the same corporation, gives rise to no taxable gain or deductible loss. Section 1036 applies to exchanges of stock between corporations and individual stockholders, and between individual stockholders. However, §1036 does not apply if common stock in one corporation is exchanged for common stock in another corporation. An exchange of common stock for preferred stock, or of preferred stock for common stock, or of stock for bonds of the same corporation, is taxable unless made pursuant to a tax-free exchange in a corporate reorganization.

If there are several classes of common or preferred stock outstanding, exchanges of any class of common for a different class of common is permissible, even though the different classes may have different voting rights. The same is true for different classes of preferred stock also.

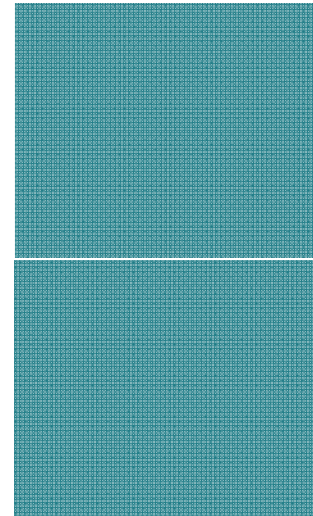
If in an exchange of common-for-common or preferred-for-preferred, money or property is received having a fair market value (FMV), then the gain (but not the loss) is recognized. Such gain is taxable to the extent of the money or FMV of the property received which is not exempt.

Note: An exchange of convertible preferred stock for common stock in the same corporation is not exempt from taxation under §1036. However, such a transaction may be treated as a recapitalization under IRC §368, and qualify as a tax-free exchange under IRC §354.

Section 1037 Certain Exchanges of United States Obligations: Obligations issued by the United States may be exchanged tax-free for other such obligations in tax years ending after September 22, 1959. However, such transactions are tax-free only if there are Regulations issued by the Secretary of the Treasury to that effect. The holding period of the obligation that is exchanged may be tacked on to the holding period of the obligation received.

Section 1038 Certain Recquisitions of Real Property: If a sale of real property gives rise to a debt secured by the property sold, and the seller later repossesses such property in satisfaction of the debt, then the gain or loss realized by the seller on the repossession is treated under the rules of IRC §1038.

Section 1039 Certain Sales of Low Income Housing Projects: IRC §1039, which allowed for the non-recognition of gain from certain sales of low-income housing projects, was repealed by the Revenue Reconciliation Act of 1990 (P.L. 101-508), generally effective November 5, 1990. However, a savings provision of the Act provides that if:



1. any provision of IRC §1039 applied to (a) any transaction occurring before November 5, 1990, or (b) any property acquired before November 5, 1990, or (c) any item of income, loss, deduction, or credit taken into account before November 5, 1990, and

2. the treatment of such transaction, property, or item under such provision would (without regard to the repeal of §1039) affect liability for tax periods ending after November 5, 1990, then the repeal of §1039 will not affect the treatment of such transaction, property, or item for purposes of determining liability for tax for periods ending after November 5, 1990.

The application of §1039 is not mandatory; the property owner has the option of electing application. There are various technical definitions that must be complied with in order to elect a §1039 exchange (those not affected by the repeal).

Section 1040 Transfers of Certain Real Estate to Qualified Heirs: IRC §1040 limits the amount of gain that is taxable to an estate or trust that transfers appreciated farm property or closely held business real estate where the real estate has been valued for estate tax purposes under the "special use" valuation method of IRC §2032A and is transferred to a "qualified heir" (as that term is defined in IRC §1040 and the Regulations thereunder.)

The amount of gain that is taxable to an estate or trust upon such transfer is limited to the post-death appreciation on the property. Post-death appreciation is the difference between the property FMV on the date the bequest is satisfied with estate or trust assets and its estate value as determined without regard to IRC §2032A. The rule applies to decedents dying after December 31, 1976.

The basis of the property in the hands of the heir or beneficiary is the estate's or trust's basis for the property immediately before the exchange plus the amount of gain recognized (the post-death appreciation) by the estate or trust on the exchange.

Section 1041 Transfers of Property Between Spouses or Incident to Divorce: IRC §1041 provides that no gain or loss will be recognized to the parties (1) in the case of transfers of property between spouses during marriage or (2) in the case of transfers of property to a former spouse if the transfer is incident to a divorce. Such transfers are treated as gifts and the transferee's basis of the transferred property will be the same as the basis of the transferor. Temporary Regulations provide that transfers of property to a third party on behalf of a spouse (or former spouse) may qualify under IRC §1041. See Temporary Reg. §1.1041-1.

Section 1042 Sales of Stock to Employee Stock Ownership Plans or Certain Cooperatives: Under IRC §1042, a seller may elect non-recognition of gain from the sale of "qualified securities" if certain guidelines are met. "Qualified securities" are defined in IRC §1042(c)(1)(B)(ii). There is a Statute of Limitations under §1042 as detailed in the Code and Regulations thereunder.

