

PROPOSED REGULATIONS UNDER I.R.C. SECTION 1.6011-4T: APPLICATION
OF TAX SHELTER DISCLOSURE RULES TO LIKE-KIND EXCHANGES

The following comments represent the individual views of those members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or of the Section of Taxation.

These comments were prepared by individual members of the Committee on Sales, Exchanges, and Basis with the participation of individual members of other committees. Principal responsibility was exercised by Kelly Alton and David Shechtman. Substantive contributions were made by Mary Foster, Adam Handler, and Howard Levine. The comments were reviewed by John P. Barrie of the Section's Committee on Government Submissions and by Rudy Ramelli, Council Director of the Sales, Exchanges, and Basis committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the disclosure requirements addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Comments Concerning Proposed Regulations under I.R.C. section 1.6011-4T Regarding the Application of the Tax Shelter Disclosure Rules to Like-Kind Exchanges

Our comments are divided into two parts. The first part discusses the policy concerns that we believe support the exclusion of like-kind exchanges under section 1031 from the definition of a tax shelter. The second part discusses the changes to Form 8824, the form used to report like-kind exchanges, that we believe will enhance compliance with the existing requirements of section 1031. In particular, we propose a number of changes that would require the reporting of previously unreported and potentially abusive indirect related party exchanges.

Policy Justifications for Exclusion of Section 1031 Like-Kind Exchanges from the Scope of Proposed Treasury Regulation Section 1.6011-4T

We believe that section 1031 like-kind exchanges should be added to the “angel” list of transactions excepted from the tax shelter disclosure requirement that are set forth in section 1.6011-4T(b)(6)(iii) of the proposed regulations. As currently drafted, the proposed regulations would require disclosure of like-kind exchanges that involve a book/tax difference of more than \$10,000,000. Most like-kind exchanges are deferred exchanges using qualified intermediaries. Such exchanges are treated as a sale followed by a purchase for GAAP purposes, thus generating book income, although treated a nonrecognition event for tax purposes.

Like-kind exchanges are not tax shelters. These exchanges are a legitimate means of tax deferral that have been a part of the federal income tax law since 1921. Like-kind exchanges benefit a broad spectrum of taxpayers, from individuals to large corporations. These exchanges are not “marketed” as a means of achieving an arguably impermissible reduction of tax liability, and statutory and regulatory safeguards currently exist to address like-kind exchange transactions that may be abusive. *See, e.g.*, section 1031(f) and (h) and Treas. Reg. section 1.168(h)-1 (like-kind exchanges involving tax-exempt use property).

The conceptual basis for nonrecognition of gain in a like-kind exchange is that the taxpayer has not cashed out and has continued his investment in similar property. Further, the carryover basis provision of section 1031(d) ensures that the gain not recognized on a like-kind exchange is only deferred, and that a subsequent disposition of the property received in the exchange for cash or nonlike-kind property will trigger taxable gain.

Like-kind exchanges are presently required to be disclosed on the taxpayer’s tax return by attaching Form 8824 (Like-Kind Exchanges). Thus, the fundamental objective of section 1.6011-4T regulation, to require disclosure, is currently mandated. Recently, the Service and Treasury issued Rev. Rul. 2002-83, 2002-49 I.R.B. 927, which addressed indirect related party exchanges under section 1031(f)(4). As noted in this ruling, these exchanges may violate section 1031 by enabling the taxpayer or a related party to shift

basis between the exchanged properties and thereby shield the receipt of cash from gain recognition. *See also* Technical Advice Memoranda 9748006 and 200126007. In light of this continuing problem, we believe that the most appropriate way to implement the tax shelter regulation's goal of disclosure is to amend Form 8824 to require submission of information sufficient to enable the IRS to identify these transactions.

Presently, Form 8824 read literally does not require disclosure of the type of transaction described in Rev. Rul. 2002-83. Rather, the form solicits information regarding only direct related party exchanges. The questions posed by the form are designed to identify a transaction that may violate section 1031(f)(1) and may or may not qualify for one of the exceptions under section 1031(f)(2). There are no questions which solicit information that would enable an agent to identify a potentially abusive indirect related party exchange if the taxpayer chooses to read the form's question on line 7 ("Was the exchange made with a related party?") in a literal manner. In an exchange involving a qualified intermediary, the taxpayer's exchange technically occurs between the qualified intermediary and the taxpayer. Thus, a taxpayer who engaged in an indirect related party exchange simply checks the "No" box on line 7 and bypasses the questions in Part II which solicit information on the specific facts of the related party exchange.

In the spirit of the tax shelter regulation's focus on disclosure, we believe that Form 8824 should be amended to add additional questions and additional instructions specifically designed to elicit information that would identify indirect related party exchanges that may violate section 1031(f)(4). In the second part of our comments we have set forth specific changes to the Form 8824 and the instructions thereto that we believe will accomplish the appropriate level of disclosure.

We also believe that compliance with section 1031 would be enhanced by an additional change to Form 8824 targeted at ensuring that timely identifications are made. In order that the replacement property received by a taxpayer in a deferred like-kind exchange be considered like-kind property, it must be identified in a timely manner. Section 1031(a)(3) requires that replacement property must be identified on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange. Pursuant to section 1.1031(k)-1(c)(2), replacement property is considered identified only 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 (i) the person obligated to transfer the replacement property to the taxpayer (regardless of whether that person is a disqualified person) or (ii) any other person involved in the exchange other than the taxpayer or a disqualified person. Most deferred exchanges are accomplished through the use of qualified intermediaries, and in most, but not all cases, the taxpayer makes the identification to the qualified intermediary, which is the party obligated to transfer the property to the taxpayer. To enable an agent to verify that the replacement property received was a property properly identified, we suggest that the form be amended to request the name and address of the party to whom the identification was made.

Lastly, to further strengthen the incentive to comply with existing disclosure requirements, we suggest that the tax shelter regulation condition the exclusion from tax shelter reporting on the filing of a Form 8824 for the exchange at issue.

Recommended Changes to Form 8824 and Instructions

1. Changes to Form 8824

(a) Add a new question 6 in Part I:

6. To whom did you send the written identification of the like-kind property received:
[insert lines requesting name and address of recipient of replacement property
identification]

[Question 7 is the same as current question 6.]

(b) Add a new question 8 (revised version of current question 7) in Part I:

8. Did you receive like-kind property from a related party or from a qualified intermediary or other accommodator that acquired the property from a related party (see instructions), or did you transfer like-kind property to a related party or to a qualified intermediary or other accommodator that the qualified intermediary or other accommodator sold or disposed of to a related party (see instructions)? **Yes** box and **No** box.

If "Yes," complete Part II, lines 9, 10, 11, and 12.

[Line 9 is the same as current question 8, which asks for the name and the address of the related party.]

(c) Add a new question 10 to Part II:

10. If you transferred your like-kind property directly or indirectly (through a qualified intermediary or other accommodator) to a related party, and acquired your like-kind property directly or indirectly (through a qualified intermediary or other accommodator) from a related party or an unrelated party:

- a. during this tax year (and before the date that is 2 years after the last transfer of property that was part of the exchange), did the related party sell or dispose of the like kind property received from you in the exchange? ___ Yes. ___ No.
- b. during this tax year (and before the date that is 2 years after the last transfer of property that was part of the exchange), did you sell or dispose of the like kind property received in the exchange? ___ Yes. ___ No.

*If both a and b are “No,” and this is the year of the exchange, go to Part III.
If both a and b are “No,” and this is not the year of the exchange, stop here.
If with line a or b is “Yes,, complete Part III and report this year’s tax return
the deferred gain (or loss) from line 24 **unless** one of the exceptions on line 12
applies. See **Related party exchanges** in the instructions.*

(d) Add a new question 11 to Part II:

11. If you transferred your **relinquished property** directly or indirectly (through a qualified intermediary or other accommodator) to an **unrelated party**, and acquired your **replacement property** directly or indirectly (through a qualified intermediary or other accommodator) from a **related party**, you must either (a) establish to the satisfaction of the IRS that neither the exchange nor the disposition had tax avoidance as its principal purpose or (b) explain why these transactions were not part of a series of transactions intended to avoid the related party exchange limitations. Please attach an explanation (see **Related party exchanges** in the instructions).

[Question 12 is the same as current question 11]

2. Changes to Instructions to Form 8824

(a) Instructions for Line 8:

The instructions for line 8 should explain what is the meaning of qualified intermediary and other accommodator (e.g., exchange accommodation titleholder, etc.) The following is suggested as an appropriate instruction:

An accommodator is used to facilitate a like-kind exchange. A qualified intermediary is a type of accommodator often used in like-kind exchanges. For details, see Regulations section 1.1031(k)-1(g)(4). A qualified intermediary is a person other than yourself or a disqualified person and enters into a written exchange agreement with you and, as required by the exchange agreement, acquires the like-kind property from you, sells or disposes of that property, acquires other like-kind property, and transfers that property to you. See special rules regarding disqualified person in Regulations section 1.1031(k)-1(k). Another type of accommodator commonly used is an exchange accommodation titleholder (EAT) as defined in Rev. Proc. 2000-37, 2000-2 C.B. 308, which facilitates an exchange of property held in a qualified exchange accommodation arrangement (QEAA). You can find Rev. Proc. 2000-37 on page 308 of Internal Revenue Bulletin 2000-40 at www.irs.gov/pub/irs-irbs/irb00-40.pdf.

(b) Additional Related Party Exchanges Instructions:

The section on Related party exchanges that is already in the instructions should be augmented to address the section 1031(f)(4) concerns. The following changes are suggested to be added as paragraph four of this section:

The anti-avoidance rule of section 1031(f)(4) may apply if the taxpayer engages in a series of transactions at the completion of which (a) two related parties have “swapped” basis in certain properties (as would be the case in a direct related party exchange), (b) one of the related parties either immediately or within two years thereafter disposes of the property and receives cash or other property from a third party, and (c) the transactions were structured to avoid the related party rules of section 1031(f)(1). See, for example, Rev. Rul. 2002-83, 2002-49 I.R.B. 927, which holds that a taxpayer’s receipt of replacement property (through a qualified intermediary) from a party related to the taxpayer (who receives cash from the qualified intermediary) violates section 1031(f)(4) even though the taxpayer’s purported exchange is with the qualified intermediary and not directly with the related party. The exchange in Rev. Rul. 2002-83 was considered to be a transaction that was structured to avoid the related party rules of section 1031(f)(1) because the qualified intermediary was used to disguise the role of the related party and thereby attempt to qualify an exchange for section 1031 treatment, which, if the exchange had been done directly, would have been disqualified by reason of section 1031(f)(1).