

COMMENTS ON PROPOSED AMENDMENT TO THE REGULATIONS UNDER SECTION 1031 ON DEFINITION OF “DISQUALIFIED PERSON”

These Comments are the individual views of members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association.

These Comments were prepared by the individual members of the Committee on Sales, Exchanges & Basis of the ABA Section of Taxation. Principal responsibility was exercised by David Shechtman. Substantive contributions were made by Ron Platner. The Comments were reviewed by Laurence Reich of the Section’s Committee on Government Submissions and by Stanley Blend, Council Director for the Committee on Sales, Exchanges & Basis.

Although members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the federal tax principles 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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EXECUTIVE SUMMARY

In general, we commend the stated goal of the proposed amendment to Treas. Reg. §1.1031(k)-1(k)(4) of permitting banks, as regulated institutions, to continue in their traditional role as independent holders of funds in like-kind exchange transactions under Section 1031. As noted in the preamble to the proposed regulations, recent legislative and regulatory changes affecting financial institutions generally have made the application of the “disqualified person” limitation under Treas. Reg. §1.1031(k)-1(k) more restrictive than originally intended with respect to banks and financial institutions. (As used herein, the capitalized term “Bank” refers to

a “bank” within the meaning of Section 581, the cross-reference used in the proposed regulation.)

Unfortunately, in our view, the proposed regulation falls short of its stated goal because the easing of the “disqualified person” restriction, as proposed, applies only to exchange activities conducted directly by a Bank and not to exchange activities conducted by a separate exchange “qualified intermediary” company within an affiliated group under a bank holding company (“BHC”). In our experience, most BHCs, for valid business and regulatory reasons, conduct their “qualified intermediary” businesses through a separate subsidiary corporation apart from the Bank. Accordingly, we recommend that the scope of the proposed regulation be expanded to cover certain direct or indirect subsidiaries of a BHC whose principal activity consists of rendering services with respect to exchanges of property intended to qualify for non-recognition of gain under Section 1031 (a “QI Sub”).

In addition, we note a disparity between the effective date as set forth in the preamble to the proposed regulation and the one set forth in the text of the proposed regulations. Because the proposed regulation deals with financial industry legislative and regulatory changes which already are in effect, we recommend that the more favorable effective date set forth in the preamble govern. For the same reason, we believe the preamble to the final regulations should explicitly provide that no negative inference is to be drawn from the amendment for certain pre-effective date transactions. Finally, we suggest that the general definition of “disqualified person” be amended to codify the rule regarding services as an “exchange accommodation titleholder” set forth in Rev. Proc. 2000-37, 2000-40 I.R.B. 1.

SPECIFIC COMMENTS ON THE PROPOSED AMENDMENT TO THE SECTION 1031

“DISQUALIFIED PERSON” REGULATIONS (REG. 107175-00; JANUARY 17, 2001)

I. RESTRICTIONS SHOULD BE EASED FOR QI SUBS, AS WELL AS FOR BANKS

Background

Treas. Reg. §1.1031(k)-1(g) establishes four safe harbors, the use of which will result in a determination that a taxpayer is not in actual or constructive receipt of money or other property for purposes of deferred like-kind exchanges under Section 1031. Taxpayers engaging in deferred like-kind exchanges under Section 1031 often use a combination of the “qualified intermediary” safe harbor under Treas. Reg. §1.1031(k)-1(g)(4) and the “qualified trust” or “qualified escrow account” safe harbor under Treas. Reg. §1.1031(k)-1(g)(3). Each of these safe harbors requires that the person serving as qualified intermediary, the holder of the qualified escrow account, or the trustee of the qualified trust, as the case may be, not be a “disqualified person” with respect to the taxpayer, as defined in Treas. Reg. §1.1031(k)-1(k).¹

Under Treas. Reg. §1.1031(k)-1(k)(2), the definition of “disqualified person” with respect to a taxpayer includes certain individuals related to the taxpayer, certain entities controlled by the taxpayer, and a person who is an employee or agent of the taxpayer at the time of the transaction, subject to the following rules: (i) a person who has acted in various specified capacities for the taxpayer, including as the taxpayer’s “investment banker or broker,” within the 2-year period

¹ It should be noted that the “disqualified person” rules are also relevant to so-called “reverse” or “parking” exchanges under Rev. Proc. 2000-37, 2000-40 I.R.B. 1. Rev. Proc. 2000-37 provides a safe harbor for these types of exchanges through the use of an “exchange accommodation titleholder” (“EAT”). Under Section 4.02(1) of Rev. Proc. 2000-37, the EAT may not be a “disqualified person.” To the extent financial institutions are willing and able to act as EATs, it is almost certain that the entity so serving will not be a Bank due to regulatory restrictions on a Bank’s ownership of real property.

ending on the date the exchange commences (the “2-year period”) is per se a disqualified person, and (ii) performance of “routine financial, title insurance, escrow, or trust services for the taxpayer by a financial institution, title insurance company, or escrow company,” as well as performance of services exclusively with respect to exchanges, are not taken into account in determining disqualified person status. Under Treas. Reg. §1.1031(k)-1(k)(4), a person is a disqualified person if that person and a person described in paragraph (k)(2) bear a relationship described in either Section 267(b)² or Section 707(b). Included among the Section 267(b) relationships are “two corporations which are members of the same controlled group.”

Banks (usually through their trust departments) often serve directly as holders of qualified escrow accounts or trustee of qualified trusts which hold and invest exchange proceeds for related and unrelated qualified intermediaries. Bank trust services are subject to a variety of regulatory requirements and oversight. On the other hand, BHCs most often perform qualified intermediary services through separate QI Subs.³ This is done for a variety of regulatory, administrative, and other business reasons.

By carving out institutions that provide “routine financial services” from the definition of a “disqualified person,” Treas. Reg. §1.1031(k)-1(k) clearly intended to encourage the use of financial institutions as providers of intermediary, escrow, and trustee services. Indeed, small real estate investors, who comprise a large part of the like-kind exchange marketplace, will often

² For this purpose, however, “10 percent” is substituted for “50 percent” each place it appears.

³ We are aware of some instances in which a Bank forms a single-member limited liability company to perform qualified intermediary services. However, under Treas. Reg. §301.7701-2(c)(2)(ii) a Bank cannot treat a wholly-owned non-bank entity as a disregarded entity for purposes of applying the special rules of the Internal Revenue Code applicable to Banks.

want the benefit of FDIC insurance provided by Banks for their exchange funds. At the same time, the regulation discourages the use of investment bankers or brokers (as well as the taxpayer's employees, accountants, real estate brokers or attorneys) for these services through the special 2-year "lookback" rule.

The proposed regulation sets forth additional language to be added to the end of Treas. Reg. §1.1031(k)-1(k)(4). As written, this language would permit Banks (as defined in Section 581) to provide trustee, escrow, or qualified intermediary services for a taxpayer with respect to exchanges notwithstanding that a member of the same BHC controlled group (within the meaning of Section 267(b) as modified) provided investment banking or brokerage services to the taxpayer within the 2-year period. The language, as written, does not cover services provided by a QI Sub within the controlled group.

Recommendation

In order to implement fully the stated intention of the proposed regulation, it is recommended that both Banks and QI Subs within a BHC control group be permitted to provide exchange services notwithstanding the provision of investment banking or brokerage services to the taxpayer by other members of the BHC group during the 2-year period.⁴ By covering both Banks and QI Subs, the regulation will permit BHC controlled groups to structure their exchange accommodation services in a manner consistent with their regulatory and administrative needs.

⁴ Under our suggested language, the QI Sub must be wholly owned by a Bank or by the parent BHC. As a result, a brokerage or investment banking entity within the BHC would not be able to provide exchange services (directly or through a directly controlled entity) if it otherwise were a "disqualified person." Accordingly, brokerage or investment banking firms within a BHC group would not be treated more favorably than independent brokerage or investment banking firms.

The special status for QI Subs is also consistent with the special status afforded under the “disqualified person” regulations to certain individuals and entities engaged exclusively in providing services with respect to transactions intended to qualify under Section 1031.

In order to extend the benefit of the proposed regulation to QI Subs within a BHC control group, we suggest that the language of the proposed amendment to Treas. Reg. 1.1031(k)-1(k)(4) be revised and restated in its entirety as follows:

However, where a person described in paragraph (k)(2) by reason of providing investment banking or brokerage services to the taxpayer within the 2-year period is a member of a controlled group (as determined under section 267(f)(1), substituting “10 percent” for a “50 percent” where it appears) which includes a bank (as defined in section 581), then, with respect to transfers of relinquished property made by a taxpayer on or after [the effective date], this paragraph (k)(4) shall not apply

(i) to a bank that is a member of the same controlled group; or

(ii) to another member of the same controlled group if:

(A) the principal activity of such other member is rendering services with respect to exchanges of property intended to qualify for nonrecognition of gain or loss under section 1031; and

(B) all of the outstanding stock of such other member is owned either by a bank or by the common parent corporation (as determined under section 1563(a)(1)) of the controlled group.

To clarify the intent of this language, it is further recommended that the following example be added to the end of Treas. Reg. §1.1031(k)-1(k)(5):

Example 4: (i) C is a wholly-owned subsidiary of Bank F, a bank as defined in section 581. C’s principal activity is acting as an intermediary to facilitate like-kind exchanges. For each of its deferred exchanges, C establishes an escrow or trust account with Bank F to secure its obligation to complete the exchange. G is a member of same controlled group as C and Bank F and is engaged in the securities brokerage business. G is currently providing brokerage services to B. B and C enter into an exchange agreement whereby B retains C to

facilitate an exchange and B transfers relinquished property pursuant to such exchange on [effective date].

(ii) G is a disqualified person. Neither C nor Bank F is a disqualified person notwithstanding the combination of their relationship to G and G's rendering of services as a broker to B (see paragraphs (k)(4)(i) and (k)(4)(ii) of this section).

II. DISCREPANCY REGARDING EFFECTIVE DATE; NO NEGATIVE INFERENCE FOR PRE-EFFECTIVE-DATE TRANSACTIONS

Background

There is a discrepancy between the effective date of the proposed regulation, as set forth in Prop. Reg. §1.1031(k)-1(k)(4) and the effective date as stated in the preamble thereto. The preamble provides that the proposed regulation is effective for “transfers of property made by a taxpayer on or after January 17, 2001.” The proposed regulation itself, however, provides that it “applies to transfers of property made by the taxpayer ON OR AFTER THE DATE ON WHICH THESE REGULATIONS ARE PUBLISHED AS FINAL REGULATIONS” (emphasis added).

Recommendation

Because the technicalities of the “disqualified person” rule may provide a “trap for the unwary” and because the legislation permitting consolidation of services provided by financial institutions is already in effect, we believe the more liberal effective date provision set forth in the preamble should govern. Furthermore, for the same reason, we believe the preamble to the final regulation should state explicitly that no negative inference is to be drawn from the amendment to Treas. Reg. §1.1031(k)-1(k)(4) regarding the status of pre-effective-date transactions in which members of the same BHC controlled group provided exchange services and investment banking and brokerage services within the 2-year period. Rather, the determination as to whether the entity providing the exchange services is a “disqualified person”

for pre-effective-date transactions should depend upon all the facts and circumstances, including (i) whether the business unit providing the exchange services was managed independently of the business unit providing the investment banking or brokerage services and (ii) whether the brokerage or investment banking services provided may be viewed as “routine financial services” under the circumstances.⁵

As noted in the preamble to the proposed regulation, the Gramm-Leach-Bliley Act, Public Law 106-102 (the “GLB Act”), eliminated most restrictions of prior law on the range of financial activities conducted by BHC controlled groups. The GLB Act was enacted on November 12, 1999. Moreover, various changes in policy by the Federal Reserve System in years prior to the enactment of the GLB Act allowed BHC controlled groups to offer brokerage and investment banking services on a limited basis, and some BHC controlled groups were able to offer a full range of such services based upon their “grandfathered” status under prior law. In our view, the benefit provided taxpayers by the proposed regulation should not be undercut by any inference that pre-effective-date transactions will be subject to scrutiny in all cases where there was an overlap between exchange services and investment banking or brokerage services within a BHC controlled group.

III. CODIFICATION OF DISQUALIFIED PERSON EXEMPTION FOR “EXCHANGE ACCOMMODATION TITLEHOLDER” SERVICES

Background

As noted above, Rev. Proc. 2000-37 provides a safe harbor for so-called “reverse” or “parking” exchanges through the use of an “exchange accommodation titleholder” (“EAT”).

⁵ For example, the provision of securities brokerage services to an individual taxpayer, charging standard commission rates, likely qualifies as “routine.” The provision of investment banking services regarding a potential disposition of a substantial business unit by a corporate taxpayer may not qualify as “routine.”

Under Section 4.02(1) of Rev. Proc. 2000-37, the EAT may not be a disqualified person. Section 3.03 of Rev. Proc. 2000-37 provides further that “services for the taxpayer in connection with a person’s role as the [EAT]. . .shall not be taken into account in determining whether or not that person or a related person is a disqualified person.”

Recommendation

We believe the scope of the proposed amendments to Treas. Reg. §1.1031(k)-1(k) should be expanded to codify the disqualified person rule set forth in Section 3.03 of Rev. Proc. 2000-37. This will provide greater certainty to taxpayers regarding the authority to be afforded this rule. Accordingly, we suggest the following language (in boldface below) be added to the end of Treas. Reg. §1.1031(k)-1(k)(2)(i):

Solely for purposes of this paragraph (k)(2), performance of the following services will not be taken into account --

(i) Services for the taxpayer with respect to exchanges of property intended to qualify for nonrecognition of gain or loss under section 1031, **including, without limitation, services related to the temporary acquisition of title to the taxpayer’s intended replacement property or relinquished property, the construction of improvements on such property, and the managing or leasing of such property.**