Acquisitions, Dispositions & Structuring Techniques Corner

By Richard M. Lipton

"Securities" and Like-Kind Exchanges

As all tax practitioners know, Code Sec. 1031(a) mandates nonrecognition of gain or loss upon a like-kind exchange. However, exchanges of certain types of property are not subject to this rule. This column addresses the meaning of the word "securities" in the exception set forth in Code Sec. 1031(a)(2)(D), which provides that nonrecognition is not available for any exchange of stocks, bonds, notes or other securities. This issue has come to the forefront as more and more interests in property, including various interests in real estate, such as tenancy-in-common (TIC) interests[1] or interests in a Delaware statutory trust (DST),[2] are acquired by taxpayers as replacement property in like-kind exchanges either (1) after being registered under the securities law or (2) pursuant to an exemption from registration.[3]

This question needs to be addressed because of the broad definition of a "security" for purposes of the U.S. securities law. The Securities Act of 1933 (the "Securities Act"), which often is referred to as the "truth in securities" law, requires that investors receive financial and other significant information concerning securities being offered for sale and prohibits deceit, misrepresentations and other fraud in the sale of securities.[4] A primary means of accomplishing the purposes of the Securities Act is through the requirements that (1) securities sold in the United States generally must be registered with the Securities and Exchange Commission (the SEC), unless an exemption from registration is available and (2) the issuer of the securities must provide disclosure to potential investors.[5]

The SEC and the courts have taken a broad view of the definition of a "security" to achieve the legislative objective of full disclosure of the facts and risks of an

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investment. In *SEC v. W.J. Howey Co.*,[6] the U.S. Supreme Court ruled that an arrangement is an investment contract, and therefore a "security" for purposes of the Securities Act by looking to "whether [it] involves an investment of money in a common enterprise with profits to come solely from the efforts of others," emphasizing "[t]he statutory policy of affording broad protection to investors."[7] *Howey* involved sales of orange groves along with optional service contracts (which most investors opted to purchase).[8] Upon payment of the full purchase price, the purchaser obtained a warranty deed; purchases generally were of narrow strips of land, with an average size of 1.33 acres.[9] The service contract gave the service company a leasehold interest and covered cultivation of the groves and harvesting and marketing of crops.[10] Thus, fee ownership of real estate was treated as a "security" in *Howey*.

The Court more recently clarified that there was no reason to distinguish between variable and fixed returns for purposes of the *Howey* "profits" test.[11] The Court also said that the profit referred to in *Howey* is the profit that investors seek on their investments, rather than the profits of the scheme in which they invest.[12] In addition, the Court emphasized that the definition of a "security" for purposes of the Securities Act was intended to encompass a variety of situations.[13] The SEC Division of Corporation Finance also has issued a no-action letter that refused to find that a triple-net lease arrangement sold to a single investor or to multiple investors as tenants-in-common is not a security.[14]

Thus, for purposes of the securities laws, a security is very broadly defined. Is the definition the same for purposes of Code Sec. 1031(a)(2)(D)? Again, a historical background is helpful. The statutory predecessor of Code Sec. 1031, Code Sec. 202(c)(1), was enacted as part of the Revenue Act of 1921.[15] In 1923, Congress amended Code Sec. 202(c)(1) to exclude from the like-kind exchange provision "stock, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest" held for investment.[16] The legislative history explains the reason for this amendment by quoting a letter from the Secretary of the Treasury stating:

> The revenue act of 1921 provides, in section 202, for the exchange of property held for investment for other property of a like kind without the realization of taxable income. Under this section a taxpayer who purchases a bond of $1,000 which appreciates in value may exchange that bond for another bond of the value of $1,000, together with $100 in cash (the $100 in cash representing the increase in the value of the bond while held by the taxpayer), without the realization of taxable income. This provision of the act is being widely abused. Many brokers, investment houses, and bond houses have established exchange departments and are advertising that they will exchange securities for their customers in such a manner as to result in no taxable gain. Under this section, therefore, taxpayers owning securities which have appreciated in value are exchanging them for other securities and at the same time receiving a cash consideration without the realization of taxable income, but if the securities have fallen in value since acquisition will sell them and in computing net income deduct the amount of the loss on the sale. This result is manifestly unfair and destructive of the revenues. The Treasury accordingly urges that the law be amended so as to limit the cases in which securities may be exchanged for other securities without the realization of taxable income to those cases where the exchange is in connection with the reorganization, consolidation, or merger of one or more corporations.[17]

The 1923 amendments to the predecessor of Code Sec. 1031 also replaced the prior "boot" rule, which provided that boot received reduced the basis of qualifying property received and that gain was recognized only if the amount of boot received exceeded such basis, with a rule requiring recognition of gain to the extent of the amount of boot received.[18]

In 1934, Congress reconsidered the nonrecognition provisions originally enacted in 1921 and made extensive changes to some of those nonrecognition provisions, but concluded that the like-kind exchange rules did not require amendment, stating:

> The law has provided for 12 years that...profit or loss is recognized in the case of exchanges of notes or securities, which are essentially like money; or in the case of stock in trade; or in case the taxpayer exchanges the property comprising his original investment for a different kind of property; but if the taxpayer's money is still tied up in the same kind of property as that in which it was originally invested, he is not allowed to compute and deduct his theoretical loss on the exchange, nor is he charged with a tax upon his theoretical profit. The calculation of the profit or loss is deferred until it is realized in cash, market-

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> able securities, or other property not of the same kind having a fair market value.
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> The Treasury Department states that its experience indicates that this provision does not in fact result in tax avoidance. If all exchanges were made taxable, it would be necessary to evaluate the property received in exchange in thousands of horse trades and similar barter transactions each year, and for the time being, at least, claims for theoretical losses would probably exceed any profits which could be established. The committee does not believe that the net revenue which could thereby be collected, particularly in these [depression] years, would justify the additional administrative expense. Consequently, the exchange provisions have not been changed.[19]

In fact, the like-kind exchange rules have "remained substantially intact" since the 1923 amendments discussed above.[20]

This difference in the definitions of the same word (securities) for purposes of the tax laws and the securities laws is appropriate because of the differing purpose of these rules.

The meaning of the phrase "other securities" has neither been defined precisely, nor considered frequently in the context of Code Sec. 1031 in the nearly eighty-five years since the phrase was added to the predecessor of Code Sec. 1031. The term "securities" is used in a number of other sections of the Code, including Code Secs. 165(g), 1083(f) and 1236(c), all of which include narrow definitions of the term "securities." The term also has been narrowly defined in various Treasury Regulations.[21] These narrow definitions serve the purpose of the relevant revenue statute and stand in contrast to the broad definition in the securities statute.

The fact that an investment is treated as a security for purposes of the securities laws, which define securities broadly because they are designed to protect investors, is not indicative of the appropriate result under the revenue laws. In a series of General Counsel's Memoranda (GCM), the IRS considered whether whiskey warehouse receipts should be treated as securities for purposes of Code Sec. 1031. In GCM 35,242,[22] after discussing the definitions of "securities" in various sections of the Code, the IRS stated "we believe it persuasive that Congress has consistently defined the term 'securities' in a limited sense" in the Code and concluded that whiskey warehouse receipts were not "securities" under Code Sec. 1031. The IRS reached this conclusion, even though the SEC treated the whiskey warehouse receipts as securities for purposes of the securities law.[23] In reaching its conclusion that the whiskey warehouse receipts were not securities for purposes of Code Sec. 1031, the IRS noted that in *Plow Realty Co.*,[24] the Tax Court concluded that even though mineral deeds are "securities" under the securities laws, they are not "securities" under the predecessor of Code Sec. 543, relating to personal holding company income.[25] In *Plow Realty*, the court said "here we have a revenue statute and not a question of the exercise of police power by a state or the National Government for the protection of the public."[26]

Property other than whiskey receipts has been treated as a "security" for purposes of the Securities Act, but not for purposes of Code Sec. 1031. For example, the seminal Supreme Court case defining a "security" for purposes of the Securities Act, *Howey*,[27] involved the sale of an orange grove, which was clearly real estate for tax purposes, but a security under the Securities Act. Another common area in which this disparate treatment has applied involves interests in oil and gas properties, which are usually treated as securities for purposes of the Securities Act (because of the management involved in the property), but not as "securities" for purposes of Code Sec. 1031. Indeed, prior to adoption of Code Sec. 1031(a)(2)(D) in 1984, an interest in a general partnership qualified for like-kind exchange under Code Sec. 1031, even though such interests were often treated as securities under the Securities Act. Finally, the SEC has treated the sale of condominium units with mandatory rental pool arrangements, and other rental arrangements in which the seller emphasizes the economic benefits to the buyer to be derived from the rental of the units due to the managerial efforts of the promoter, or a person arranged by the promoter as securities under the Securities Act.[28] However, there has never been a question that condominium units can qualify for like-kind exchange treatment.[29]

Thus, from an historical perspective, the word "securities" has been interpreted differently for purposes of the securities and tax laws. This difference is likely due to the fact that Congress was concerned in 1923 about exchanges of notes or securities, which are essentially like money, whereas Congress was concerned about protect-

ing investors when Congress broadly defined "securities" for purposes of the Securities Act. By 1934, which was just a year after the enactment of the Securities Act, Congress was still viewing a "security" for purposes of Code Sec. 1031 as something that was "essentially like money." In carving out securities from like-kind exchange treatment, Congress was concerned that taxpayers' exchanges of stock with boot were going untaxed. Accordingly, Congress limited the tax-free exchange of securities to transactions satisfying the tax-free reorganization provisions. In contrast, as noted above, the SEC has taken a broad view of the definition of "security" to ensure full disclosure of the risks of investments.

This difference in the definitions of the same word (securities) for purposes of the tax laws and the securities laws is appropriate because of the differing purpose of these rules. The securities laws are intended to protect investors, so a broad definition is appropriate—Congress wanted the sellers of securities (as broadly defined) to be required to provide full disclosure to their investors. There is no similar policy underlying the definition of a "security" for purposes of Code Sec. 1031(a)(2)(D). Indeed, the literal wording of Code Sec. 1031(a)(2)(D) implies that a "security," for purposes of that provision, should be limited to something that is akin to a stock, bond or note (because the statute refers to these three items and "other securities"). Incorporation of the definition of a "security" under the securities laws for purposes of applying Code Sec. 1031(a)(2)(D) would certainly result in recognition of gain or loss in many transactions, in contrast to the reasons underlying the enactment of the predecessor provision in 1922, which was before the securities laws even existed.

As a practical matter, it seems relatively clear that the fact that an investment is treated as a "security" for purposes of the securities laws does not result *ipso facto* in the treatment of the same investment as a "security" for purposes of Code Sec. 1031(a)(2)(D). In the TIC and DST arena, even though most TIC and DST interests are sold as securities (usually pursuant to an exemption from registration under the securities laws), counsel regularly provide opinions to their clients indicating that the treatment of a TIC interest as a security for purposes of the securities law should not have any impact on a like-kind exchange. In addition to this being the correct result under the law, it is also the correct result from a tax policy and legislative history perspective. TIC and DST transactions are not vehicles for avoiding federal income tax on built-in gain present in a taxpayer's financial instrument; rather, TIC and DST transactions are a means of continuing a taxpayer's original investment in real property. A clarification that the IRS views this question similarly would always be welcome.

Endnotes

1 *See* Rev. Proc. 2002-22, 2002-1 CB 733.

2 *See* Rev. Rul. 2004-86, IRB 2004-33, 191.

3 This column is derived in part from a more detailed discussion of this issue prepared by the Tenant in Common Association entitled "Treatment of Tenancy-in-Common Interests as Securities," dated February 22, 2006.

4 The website for the Securities and Exchange Commission (*www.sec.gov*) discusses the purposes and requirements of the Securities Act.

5 Section 4(2) of the Securities Act provides the exemption from the Securities Act registration requirement for transactions not involving a public offering, but does not provide guidance on the definition of a public offering. The SEC's Regulation D provides a safe harbor for private offerings that meet its requirements. *See* 17 C.F.R. §§230.501-230.508. The requirements of Regulation D include Rule 502(c), which prohibits offers or sales by any form of "general solicitation or general advertising." 17 C.F.R. § 230.502(c).

6 *SEC v. W.J. Howey Co.*, SCt, 328 US 293, 66 SCt 1100 (1946).

7 *Id.* at 301.

8 *Id.* at 295.

9 *Id.*

10 *Id.* at 296.

11 *SEC v. Edwards*, SCt, 540 US 389, 124 SCt 892, Fed. Sec. L. Rep. ¶92,656 (2004)..

12 *Id.*

13 *Id.*

14 Triple Net Leasing, LLC, SEC No-Action Letter (Aug. 23, 2000).

15 The Revenue Act of 1921 (P.L. No. 67-98). The legislative history explains that the like-kind exchange rule and other changes to the taxation of exchanges of property included in the Revenue Act of 1921 "will, by removing a source of grave uncertainty, not only permit business to go forward with the readjustments required by existing conditions but will also considerably increase the revenue by preventing taxpayers from taking colorable losses in wash sales and other fictitious exchanges." H.R. Rep. No. 67-350, at 10 (1921), *reprinted in* 1939-1 CB (Part 2) 168, 176.

16 Act Sec 1 of P.L. No. 67-545, 42 Stat. 1560 (1923). The Ways and Means and Senate Finance Committees reported a different amendment, which would have eliminated like-kind exchange treatment for all property held for investment. After discussion on the floor of the House of the possibility that the original amendment might have barred like-kind exchange treatment for land held for investment, the specific limitation on the enumerated types of securities held for investment was substituted. *See, Seidman's History of Federal Income Tax Laws*, 1938-1861 at 797-801 (1938).

17 H.R. Rep. No. 67-1432, at 1-2 (1923); S. Rep. No. 67-1113, at 1-2 (1923), *reprinted in* 1939-1 CB (Part 2) 845-46.

18 Pub. L. No. 67-545 § 2, 42 Stat. 1560 (1923); *see* H.R. Rep. No. 67-1432, at 2-4 (1923); S. Rep. No. 67-1113, at 2-3 (1923), *reprinted in* 1939-1 CB (Part 2) 846-47; *see also* Code Sec. 1031(b) (when "property received in an exchange consists not only of property permitted by such provisions to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property").

19 H.R. Rep. No. 73-704 (1934), *reprinted in* 1939-1 CB (pt. 2) 554, 564.

20 *See* Bittker & Lokken, Federal Taxation of Income, Estates, and Gifts ¶44.2 (summarizing amendments).

21 For example, Code Sec. 1236(c) states "[f]or purposes of this section, the term 'security' means any share of stock in any corporation, certificate of stock or interest in any corporation,

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[64] *Corn Products Refining, supra* note 20, 383 US at 572 (citations omitted).
[65] *W.A. Scheuber*, CA-7, 67-1 USTC ¶9219, 371 F2d 996.
[66] *Id.* at 999.
[67] *Bush, supra* note 48.
[68] *Buono, supra* note 31 at 198.
[69] *Id.* at 205.
[70] *Winthrop, supra* note 2, 417 F2d at 908.
[71] *Id.*
[72] *Supra* note 51.
[73] *Bush, supra* note 48.
[74] *Id.*
[75] *R.E. Gordy*, 36 TC 855, Dec. 24,982 (1961); *T.A. Cary*, 32 TCM 913, Dec. 32,124(M), TC Memo. 1973-197.
[76] Unless an election is made to treat the disregarded entity as a corporation. *See* Reg. §301.7701-3.
[77] *W.T. Thrift*, 15 TC 366, Dec. 17,863 (1950); *Wray, supra* note 57.
[78] *C.E. Reithmeyer*, 26 TC 804, 813, Dec. 21,844 (1956).
[79] *Bramblett, supra* note 51; *see supra* note 56; *Gordy, supra* note 75; *Cary, supra* note 75.
[80] *See* IRS Information Letter 2002-0013, concluding that the sale of real property to related entity after obtaining subdivision approval does not qualify for capital gain; *see also E.L. Freeland*, CA-9, 68-1 USTC ¶9278, 393 F2d 573 (involving two entities that were owned and controlled by many of the same individuals).
[81] Code Sec. 707(b)(2) applies certain attribution rules for purposes of determining whether the parties are related.
[82] *See* Code Sec. 723.
[83] Code Sec. 704(c).
[84] *Cf.* Code Sec. 704(c)(1)(B); Reg. §1.704-4(b)(2). *See, e.g.*, Reg. §1.702-1(b).
[85] *W.D. Little*, CA-9, 97-1 USTC ¶50,207, 106 F3d 1445.
[86] Under former Code Sec. 1202, an individual could deduct 60% of the gain on the sale of a capital asset held for more than one year.
[87] *Little, supra* note 85, 106 F3d at 1450.
[88] *A.P. Jarret*, 66 TCM 1224, Dec. 49,384(M), TC Memo. 1993-516.
[89] *See also V. Harder*, 60 TCM 179, Dec. 46,736(M), TC Memo. 1990-371.
[90] Code Sec. 6662(b).
[91] Reg. §1.6662-3(b)(1).
[92] Reg. §1.6662-3(c)(1).
[93] Code Sec. 6662(d)(2)(B) (emphasis added).
[94] *See* IRM (20)535.1.
[95] Reg. §1.6662-3(b)(3).
[96] Code Sec. 6664(c); Reg. §1.6664-4(a); Reg. §1.6662-3(a); Reg. §1.6662-4(a).
[97] Reg. §1.6664-4(b)(1).
[98] *Id.*
[99] Reg. §1.6664-4(b)(1); *see Boyle*, SCt, 85-1 USTC ¶13,602, 469 US 241, 105 SCt 687.
[100] Code Sec. 6664(d)(3)(B)(iii).
[101] *Boyle, supra* note 99.
[102] *M. Rohrabaugh*, CA-7, 80-1 USTC ¶13,330, 611 F2d 211, 215.
[103] *See, e.g.*, Neonatology Associates P.A., 115 TC 43, 99, Dec. 53,970 (2000).
[104] *See, e.g., Sim-Air, USA, Ltd.*, 98 TC 187, Dec. 48,020 (1992); *N.N. Bellour*, 69 TCM 3010, Dec. 50,717(M), TC Memo. 1995-284; *L.D. Froehlich*, 72 TCM 1130, Dec. 51,626(M), TC Memo. 1996-487; *C. Goudas*, 72 TCM 1540, Dec. 51,701(M), TC Memo. 1996-555; *E.A. Burkes*, 75 TCM 1772, Dec. 52,570(M), TC Memo. 1998-61.
[105] *J.W. English*, 65 TCM 2160, Dec. 48,927(M), TC Memo. 1993-111.
[106] *Id.*
[107] *J.E. Zurcher*, 73 TCM 2697, Dec. 52,022(M), TC Memo. 1997-203.
[108] *Little, supra* note 85, 106 F3d at 1452.
[109] *See Kelley, supra* note 28.
[110] *See* Reg. §1.6664-4(f)(2). Query regarding the applicability of this provision in light of the amendment to Code Sec. 6662 under the American Jobs Creation Act of 2004.
[111] Reg. §1.6662-4(g)(2).
[112] *Long Term Capital Holdings*, DC Con., 2004-2 USTC ¶50-351, Aff'd, CA-2, 2005-2 USTC ¶50,575.
[113] *See R.G. Kleuner*, CA-6, 98-2 USTC ¶50,712, 154 F3d 630, 637-41; *T.P. Streber*, CA-5, 98-1 USTC ¶50,333, 138 F3d 216, 222-23, 227-29; *H.E. Osteen*, CA-11, 95-2 USTC ¶50,468, 62 F3d 356, 358-60.
[114] The American Jobs Creation Act of 2004 (P.L. 108-357).
[115] Code Sec. 6664(d)(3)(B)(ii).
[116] Reg. §1.6011-4(b) describes six categories of reportable transactions:
(1) Listed transactions.
(2) Confidential transactions.
(3) Transactions with contractual protection.
(4) Loss transactions.
(5) Transactions with significant book-tax differences.
(6) Transactions involving a brief asset holding period.

Acquisitions

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ENDNOTES

note, bond, debenture, or evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing." In addition, Reg. §1.892-3T(a)(3) provides that "the term 'other securities' includes any note or other evidence of indebtedness. Thus, an annuity contract, a mortgage, a banker's acceptance or a loan are securities for purposes of this section. However, the term 'other securities' does not include partnership interests (with the exception of publicly traded partnerships within the meaning of section 7704) or trust interests. The term also does not include commodity forward or futures contracts and commodity options unless they constitute securities for purposes of section 864(b)(2)(A)." The IRS has also taken a narrow view of the definition of security in Code Sec. 851(b)(2), where it is defined by reference to Code Sec. 2(a)(36) of the Investment Company Act of 1940. After an extensive analysis of the legislative history of Code Sec. 851(b)(2) in Rev. Rul. 2006-1, IRB 2006-2, 1, the IRS concluded that "Congress did not intend for the cross-reference to the '40 Act to incorporate into Code Sec. 851(b)(2) an expansive construction of the term 'securities'" and that "[a] construction of the term 'securities' that excludes derivative contracts providing for a total return exposure to a commodity index is consistent with Congress' intent."
[22] GCM 35242 (February 16, 1973).
[23] GCM 35242 (February 16, 1973); *see also* GCM 34500 (May 17, 1971) (concluding chances of successfully maintaining that whisky warehouse receipts are securities under Code Sec. 1031 are not favorable even though the Securities and Exchange Committee issued release that indicated that whisky warehouse receipts may be securities under applicable securities law). In the first General Counsel's Memorandum in the series, however, the Service proposed a broad view of the term securities. *See* GCM 34089 (April 12, 1969).
[24] *Plow Realty Co. of Texas*, 4 TC 600, Dec. 14,328 (1945).
[25] *Id*, at 608.
[26] *Id.*
[27] *Howey, supra* note 6.
[28] *See* SEC Release No. 33-5347, Jan. 4, 1973, 38 FR 1735, 1973 SEC LEXIS 3277.
[29] For a recent private letter ruling holding that the conversion of a cooperative into a condominium is eligible for a like-kind exchange, *see* LTR 200137032 (June 15, 2001).

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to the grantor, grantor's spouse or in discharge of the grantor's legal obligations. Accordingly, the IRS concluded in LTR 200546055 that a "living grantor's ownership interest in Trust Company or membership on its board of directors or any of its committees will not give the grantor an interest or power that would cause that grantor to be treated as an owner of any portion of the trusts under Section 677."

Similarly, the fact that no family member could participate in any discretionary distribution decision with respect to any trust of which he or she was a beneficiary was critical to ruling that the grantor trust provisions of Code Sec. 678 did not apply.