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Protecting Real Estate Investors: The Fight to Maintain the Like-Kind Standard for Exchanges under I.R.C. Section 1031 - "You Don't Have to Call Me Darling, Darling"

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ARTICLES

PROTECTING REAL ESTATE INVESTORS: THE FIGHT TO MAINTAIN THE LIKE-KIND STANDARD FOR EXCHANGES UNDER I.R.C. SECTION 1031—“YOU DON’T HAVE TO CALL ME DARLING, DARLING”*

John R. Dorocak**

I. INTRODUCTION

The tax advantages of real estate investors have been under a steady stream of attack by the Internal Revenue Service (IRS) in recent years, at least until the 1993 Act.1 Recently, the Service attempted to eliminate one of the last remaining advantages to real estate investing: the deferral of gain by like-kind exchanges under Internal Revenue Code (I.R.C.) § 1031.2 Besides an array of other

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* DAVID ALLAN COE, You Don't Have to Call Me Darlin', later retitled, You Never Called Me By My Name, For The Record—The First 10 Years (Columbia Records 1975).

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1. The 1986 Tax Reform Act amended § 465 to extend the at risk rules to real estate, extended the depreciation periods in § 168, added § 469 on passive activity loss limitations (specifically classifying all rental real estate as passive), and repealed the capital gains preference tax. I.R.C. §§ 168, 465, 469 (West 1992). The Revenue Reconciliation Act of 1988 prohibited real estate dealers from using the installment method to report gain from installment sales by amending § 453. I.R.C. § 453 (West 1992). The 1993 Act, 469(c)(7), will allow real estate professionals (with rental real estate losses) to more easily deduct losses "and no threats are being voiced against tax deferred exchanges, at least not at this time . . . ." The Kiplinger Tax Letter (June 18, 1993) (Emphasis original).

2. I.R.C. § 1031 (West 1992). One of the key advantages accorded real estate under the like-kind provisions is the broad definition of like-kind: land, whether improved or unimproved, is of like-kind. Treas. Reg. § 1.1031(a)-1(b) (1991). See infra note 14 regarding the stricter interpretation for personality. See, however, Howard J. Levine & Allen J. Littman, The Final Regulations on Exchanges of Personal Property, Multiple-Asset Exchanges, and
assaults on a real estate investor’s use of § 1031, the IRS’s most direct challenge has been an attempt to change the standard for the exchanged properties from “like-kind” to “similar or related in service or use,” the current standard under I.R.C. § 1033. The House proposed this change in the 1989 Revenue Reconciliation Act, although the House version was not enacted.

The like-kind standard for avoiding recognition of gain is relatively easy to meet when one parcel of realty is exchanged for another; all land, whether improved or unimproved, is like-kind. A similar-use standard for exchanged properties is harder to meet. A leased-out apartment building and a leased-out office building might well be similar use (i.e. rental), but a leased-out apartment building and an owner-occupied office building probably are not.

It is the position of this article that the 1989 House proposal to change the standard for deferring gain was ill-conceived for several

Deferral Exchanges Under Section 1031, 19 J. Real Est. Tax 91 (1992). In that article the authors state: “The new examples in the final deferred regulations, however, imply that improvements to real property can change the nature or character of real property. This apparently poor choice of words should be clarified.” Id. at 101-02 (emphasis added). They are discussing Treas. Reg. § 1.1031(k)-1(d)(1) and 1.1031(k)-1(d)(2) and examples 2 and 4. Id. They further explain as follows:

The final regulations add some new examples and alter an existing example to illustrate the requirement that the property received before the end of the exchange period must be “substantially the same property as identified.”

Taken together, the “nature or character” analyses of Examples 2 and 4 of the final regulations seem to confuse the issue at hand, namely, whether the property exchanged is substantially the same property as identified. While this standard undoubtedly possesses both qualitative and quantitative dimensions, a “nature and character” analysis is also used to determine whether two properties are like kind. Long-existing regulations clarify that whether “real estate is improved or unimproved relates only to the grade or quality of the property” and not to its nature or character.

Id. at 101 (footnotes omitted). Example 2 says unimproved property on which a fence is erected is substantially the same property as identified, i.e. the erection of the fence does not change the unimproved character of the land. Id.

3. See infra part III.
4. I.R.C. § 1033 (West 1992). This section reads:
"Involuntary conversions"
(a) General rule.-If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsory or involuntarily converted—
(1) Conversion into similar property.-Into property similar or related in service or use to the property so converted, no gain shall be recognized.

6. I.R.C. § 1031 (West 1992); see infra note 35 and accompanying text.
7. See infra part IV.B.4.
reasons. First, the huge revenue estimate for the changes is questionable. Second, there is no strong theoretical reason favoring a change in the standard. Third, the current version of § 1031 has worked without major problems for the last seventy years. Rather than acting as any type of hero, as suggested by one commentator, § 1031 performs in worker-like fashion. As such, it should be allowed to continue to perform rather than being retired simply because it is not the darling of revenue raisers.

II. SECTIONS 1031 AND 1033: DESIRES OF THE PARTIES AND DIFFERENCES IN STATUTORY TREATMENT

A. Section 1031

In an exchange of like-kind properties under I.R.C. § 1031, the parties (or at least one of the exchanging parties), are seeking a deferral of the recognition of gain. Section 1031(a) provides nonrecognition of gains and losses as an exception to the § 1001(c) recognition provisions. The cost to the parties of avoiding current recognition is a continuation of essentially the same basis in the property under § 1031(d). The Tax Reform Act of 1986 increased the taxation of capital gains generally to 28%. Because of the elimination of the preferential tax rate, exchanging parties were more likely to seek deferral, especially for rapidly appreciating assets such as real estate in certain markets in the late 1980's.
The Revenue Reconciliation Act of 1990\textsuperscript{13} insured that the maximum capital gains rate would be 28%. Even with the change in the strength of real estate markets with the recession of the early nineties, anecdotal evidence is that the high capital gains rates are slowing asset dispositions. Recent complex § 1031 regulations have also chilled exchanges.\textsuperscript{14}

An example of one side of a routine § 1031 exchange would be Mr. A holding real estate with a fair market value of $100,000 and a basis of $60,000. If Mr. A exchanges with Mr. B, who also has a parcel of real estate worth $100,000, Mr. A has received a different parcel of real estate but his basis continues at $60,000. Mr. A has changed his investment from one piece of real estate to another but has maintained a real estate investment after the exchange.

In a slightly different variation of the very simple exchange, Mr. C may also have a parcel of real estate worth $100,000 and a basis of $60,000. However, Mr. C wishes to take some cash out of his investment. Mr. C therefore locates Mr. D who has $20,000 cash and a parcel of real estate with a fair market value of $80,000. On the exchange, Mr. C's gain is $40,000 because of the receipt of real estate with a fair market value of $80,000 and cash of $20,000 less a basis of $60,000. A gain of $20,000 must be recognized. The money received, together with other property which is not like-kind, is treated as boot\textsuperscript{15} under § 1031(b). Gain is only recognized under § 1031(b) to the extent of the boot. Mr. C's basis in the new parcel of real estate remains at $60,000 because under § 1031(d) his basis


\textsuperscript{15} The concept of boot is expressed in I.R.C. § 1031(b) which refers to "other property or money." "Other property" is property which is not "property permitted . . . to be received without the recognition of gain." I.R.C. § 1031(b) (West 1992).
is that of the property exchanged, decreased by money received, but increased by gain recognized.\textsuperscript{16}

Notice these rather simple illustrations of § 1031 like-kind exchanges do not involve any properties with liabilities attached. Such an absence of liabilities is relatively unusual in the real estate setting. If one party assumes a liability or takes a property subject to a liability, the other party is considered to have received money in applying § 1031, per § 1031(d), for both the basis calculation and the gain-within-boot calculation.\textsuperscript{17} The party that assumes the liability or takes property subject to a liability has indeed incurred an additional cost to be added to the basis under principles set forth by I.R.C. § 1012\textsuperscript{18} or in the Crane and Tufts cases.\textsuperscript{19}

Liabilities complicate the exchanges further when there is a "netting of boot"\textsuperscript{20} because both liabilities and cash are involved. The simplest explanation of this situation may be as follows:

Consideration given in the form of cash for other property is netted against consideration received in the form of an assumption of a liability or a transfer of property subject to a liability. Consideration received in the form of cash or other property is not, however, netted against consideration given in the form of an assumption of liabilities or a receipt of property subject to a liability.\textsuperscript{21}

The IRS will reduce received boot when the boot received constitutes

\textsuperscript{16} I.R.C. § 1031(d) provides in part:

\textit{Basis.-If property was acquired on an exchange described in this section, section 1035(a), section 1036(a), or section 1037(a), then the basis shall be the same as that of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange.}

\textit{I.R.C. § 1031(d) (West 1992).}

\textsuperscript{17} I.R.C. § 1031(d) reads in part:

\textit{For purposes of this section, section 1035(a), and section 1036(a), where as part of the consideration to the taxpayer another party to the exchange assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability such assumption or acquisition (in the amount of the liability) shall be considered as money received by the taxpayer on the exchange.}

\textit{I.R.C. § 1031(d) (West 1992).}

\textsuperscript{18} I.R.C. § 1012 (West 1992).

\textsuperscript{19} See generally Crane v. Commissioner, 331 U.S. 1 (1947); Commissioner v. Tufts, 461 U.S. 300 (1983).

\textsuperscript{20} A "netting of boot" can occur when a party both gives up boot and receives boot. The amounts given up and received may be netted against each other. If net boot is received, gain is recognized to the extent of boot. If net boot is given up, an additional amount is paid to acquire the property.

\textsuperscript{21} Howard J. Levine, \textit{Tax-free Exchanges Under Section 1031}, 567 \textit{TAX MGMT. PORTFOLIOS} (BNA) at A45 & n. 420 citing Treas. Reg. § 1.1031(d)-2 (emphasis added).
the other party's acquisition of the liabilities rather than a payment of cash.\textsuperscript{22} When cash is received, the IRS avoids netting and imposes the tax in order to get some of the cash.\textsuperscript{23}

B. \textit{Section 1033}

An involuntary conversion of property under I.R.C. § 1033\textsuperscript{24} is also excepted from the general rule of recognition of § 1001(c).\textsuperscript{25} An involuntary conversion of the property basically involves destruction, theft, or condemnation.\textsuperscript{26} If the property so involuntarily converted is converted directly into other property "similar or related in service or use" through an exchange under § 1033(a)(1), nonrecognition of gain is mandatory.\textsuperscript{27} If the property involuntarily converted is converted into money, a taxpayer may elect deferral of gain when certain rules are met under § 1033.\textsuperscript{28} Losses on involuntarily converted

\begin{itemize}
\item[22.] Mr. X receives property A. He gave up property B with a $100 liability attached and paid Mr. Y $50. The $50 cash paid is netted against the $100 liability received. The net boot to X is $50.
\item[23.] Mr. Y in note 22, \textit{supra}, has received $50 cash but takes on a $100 liability. Mr. Y may \textit{not} net the $50 cash against the $100 liability.
\item[25.] \textit{Id.} § 1001(c).
\item[26.] \textit{Id.} § 1033(a).
\item[27.] \textit{Id.} § 1033(a)(1).
\item[28.] \textit{Id.} § 1033. This section reads:
\begin{quote}
Involuntary conversions.
(a) General rule.—If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsory or involuntarily converted—
(1) Conversion into similar property.—Into property similar or related in service or use to the property so converted, no gain shall be recognized.
(2) Conversion into money.—Into money or into property not similar or related in service or use to the converted property, the gain (if any) shall be recognized except to the extent hereinafter provided in this paragraph:
(A) Nonrecognition of gain.—If the taxpayer during the period specified in subparagraph (B), for the purpose of replacing the property so converted, purchases other property similar or related in service or use to the property so converted, or purchases stock in the acquisition of control of a corporation owning such other property, at the election of the taxpayer the gains shall be recognized only to the extent that the amount realized upon such conversion (regardless of whether such amount is received in one or more taxable years) exceeds the cost of such other property or such stock. Such election shall be made at such time and in such manner as the Secretary may by regulations prescribe.
(B) Period within which property must be replaced.—The period referred to in subparagraph (A) shall be the period beginning with the date of the disposition of the converted property, or the earliest date of the threat or imminence of requisition or condemnation of the converted property, whichever is the earlier, and ending—
\end{quote}
\end{itemize}
property are not affected by § 1033; rather the usual rules of I.R.C. §§ 1231, 165, 1211, and 1212 apply.\textsuperscript{29} Where the taxpayer is seeking deferral of gain on property involuntarily converted into money (the more usual scenario), the taxpayer must affirmatively so elect and also timely purchase qualified replacement property.\textsuperscript{30} Qualified replacement property is also property "similar or related in service or use" under § 1031(a)(2) except that, for real property which has been condemned, replacement property can be like-kind under the standard of § 1031 as adopted by § 1033(g).\textsuperscript{31} Condemnations which allow for the broader test of like-kind versus "similar use" are basically takings by governmental authority.\textsuperscript{32} If only part of the money received on the conversion is reinvested, gain is recognized to the extent of the nonreinvestment.\textsuperscript{33} For example, under § 1033, Mr. A again owns a building with

\begin{itemize}
\item (i) 2 years after the close of the first taxable year in which any part of the gain upon the conversion is realized, or
\item (ii) subject to such terms and conditions as may be specified by the Secretary, at the close of such later date as the Secretary may designate on application by the taxpayer. Such application shall be made at such time and in such manner as the Secretary may by regulation prescribe.\textsuperscript{Id.}
\end{itemize}

29. I.R.C. §§ 165, 1211, 1212, 1231 (West 1992); Bruce N. Edwards, \textit{Involuntary Conversions}, 568 Tax Mngm’t (BNA), at A-1 n.7 and accompanying text.


31. I.R.C. § 1033(g) (West 1992). This section reads:

(g) Condemnation of real property held for productive use in trade or business or for investment.—

(1) Special rule.-For purposes of subsection (a), if real property (not including stock in trade or other property held primarily for sale) held for productive use in trade or business or for investment is (as the result of its seizure, requisition, or condemnation, or threat or imminence thereof) compulsorily or involuntarily converted, property of a like kind to be held either for productive use in trade or business or for investment shall be treated as property similar or related in service or use to the property so converted.

Id.

32. Treas. Reg. § 1.1033(g)-1 provides in part:

Condemnation of real property held for productive use in trade or business or for investment.

(a) Special rule in general.-This section provides special rules for applying section 1033 with respect to certain dispositions, occurring after December 31, 1957, of real property held either for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale). For this purpose, disposition means the seizure, requisition, or condemnation (but not destruction) of the converted property, or the sale or exchange of such property under threat or imminence of seizure, requisition, or condemnation.


a basis of $60,000 and a fair market value of $100,000. The state condemns the building under its eminent domain power in order to take it for the building of a freeway. The state pays Mr. A $100,000. Under § 1033(g), Mr. A can purchase like-kind property within a period of three years from the close of his taxable year in which either the earlier of the state’s taking the property or threatening to take it occurs. Mr. A can now locate Mr. B and purchase the replacement real property. However, if Mr. A’s real estate is beach-front real estate in California which is located on a cliff and which falls into the ocean following a Pacific storm, and if the insurance company pays Mr. A $100,000, Mr. A must now locate property which is “similar or related in service or use” within a period of two years (similarly measured) under § 1033(a)(2). That is, Mr. A is now under the general rules of § 1033 rather than the § 1033(g) exception.

The application of the “similar or related in service or use” standard to Mr. A for his replacement real estate is not necessarily as clear and easy as the § 1031 standard of like-kind under either § 1031 or § 1033(g). Under the § 1031 standard, Mr. A can exchange or replace real estate with real estate whether improved or unimproved. For example, if Mr. A’s property taken by the state for the freeway were a rental residential property, he could replace it with vacant land, farm land, or any type of real property. However, if Mr. A’s washed-away beach front property were a rental residence which had been generating income, Mr. A could only replace the property with similar rental residence use property which could generate a similar amount of income. If Mr. A were to replace the beach-front rental residence with any other type of real estate, he would face a confusing array of case law when attempting to determine whether certain rentals were similar or related in use.

There are several distinct differences between § 1031 and § 1033. First, § 1031 applies to voluntary exchanges; § 1033 applies to involuntary conversions. Second, § 1031 uses a like-kind standard for the exchange to receive nonrecognition; § 1033 uses a similar-use standard except for § 1033(g). Third, § 1033 has timing

34. See infra note 95 and accompanying text.
requirements of two and three years, as indicated above, depending on whether the replacement property is under the § 1033(a) rule or the § 1033(g) exception. Section 1031 has strict timing requirements under § 1031(a)(3), requiring identification of the replacement property within forty-five days of the transfer out, and receipt of the property at the earlier of 180 days after the transfer or the due date of the transferor's return for the year of the transfer. Fourth, § 1031 is mandatory if the requirements are met. Section 1033 is elective when the conversion is into money. Finally, § 1031 covers losses as well as gains. Section 1033 applies only to gains.

III. THE INTERNAL REVENUE SERVICE'S VARIOUS PROPOSED CHANGES IN § 1031

In recent years, the Internal Revenue Service has proposed a number of changes to I.R.C. § 1031 to limit the section's usefulness to taxpayers. The Tax Reform Act of 1984 added § 1031(a)(3) which requires that exchanges under § 1031 take place within certain time frames. The 1984 changes were in response to the Ninth Circuit ruling in Starker v. United States in which the court permitted the exchanging parties to defer the furnishing of replacement property virtually for as long as they wished. The IRS's project to develop regulations for § 1031(a)(3) yielded proposed regulations on May 16, 1990, and final regulations on April 24, 1991, regarding

37. See supra notes 28, 31.
38. I.R.C. § 1031(a)(3) provides:
   Requirement that property be identified and that exchange be completed not more than 180 days after transfer of exchanged property. For purposes of this subsection, any property received by the taxpayer shall be treated as property which is not like-kind property if:
   (A) such property is not identified as property to be received in the exchange on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange, or
   (B) such property is received after the earlier of:
      (i) the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or
      (ii) the due date (determined with regard to extension) for the transferor's return of the tax imposed by this chapter for the taxable year in which the transfer of the relinquished property occurs.
41. Starker v. United States, 602 F.2d 1341 (9th Cir. 1979); see infra notes 77-80 and accompanying text.
42. Starker, 602 F.2d at 1341.
deferred exchanges.\textsuperscript{43} Those regulations further limit previously developed customary practices in deferred exchanges.\textsuperscript{44}

In the time between the enactment of § 1031(a)(3) and the promulgation of the proposed regulations thereunder, the IRS sought further restrictive changes to § 1031. In 1987, the House sought to limit the amount of gain which could be sheltered by a deferred like-kind exchange of real estate to $100,000.\textsuperscript{45} However, the Treasury did not support the change and it was not enacted.\textsuperscript{46} In 1989, the IRS sought a number of changes to § 1031. The bill enacted as the Revenue Reconciliation Act of 1989 sought to prevent related parties from shifting basis to minimize gain by a process in which a like-kind exchange is followed by a disposition of property out of the related party group.\textsuperscript{47} Furthermore, the 1989 Act also added the new § 1031(h) which states that foreign real property and United States real property are not like-kind.\textsuperscript{48}

Two other changes to § 1031 were contained in the House bill in 1989 but were not enacted. First, the House would have enacted a provision supporting the IRS's position which is contrary to the Tax Court decision in \textit{Bolker v. Commissioner}.\textsuperscript{49} In that case, the Tax Court allowed an exchanging party to receive property and dispose of it shortly after the exchange.\textsuperscript{50} The IRS has ruled that such a procedure does not result in an exchange covered by § 1031.\textsuperscript{51} The proposed legislation would have required a holding period of one year before and after an exchange in order for the exchange to qualify under § 1031.\textsuperscript{52} Finally, the House bill also would have changed the like-kind standard of § 1031 to the similar-use standard now used in § 1033.\textsuperscript{53} Under the similar-use standard, the properties exchanged would have to be similar or related in service or use for the

\begin{footnotesize}
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\textsuperscript{44} See, e.g., Donald T. Williamson et al., \textit{Section 1031 Like-kind Exchanges: Selected Issues and Considerations}, 5 \textit{Tax Mgmt. Real Est. J.} 3 (1989).
\textsuperscript{45} H.R. 3545, 100th Cong., 1st Sess. § 10105 (1987).
\textsuperscript{46} \textit{Statement of Treasury Department}, Tax Notes Today (Jan. 15, 1988), 88 TNT 10-71.
\textsuperscript{47} I.R.C. § 1031(f) (West 1992).
\textsuperscript{48} I.R.C. § 1031(h) was added by Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, § 7601(a) (1989).
\textsuperscript{49} \textit{Bolker v. Commissioner}, 760 F.2d 1039 (9th Cir. 1985), \textit{aff'd} 81 T.C. 782 (1983).
\textsuperscript{50} \textit{Id.}
\textsuperscript{52} H.R. 3299, 101st Cong., 1st Sess. § 11601(a) (1989).
\textsuperscript{53} \textit{Id.}
\end{footnotesize}
exchange to result in a tax-free deferral of gain.54

The change to a § 1033 standard would have been the most far-reaching of the proposed changes. Although some of the other changes intended to cut back on the use of § 1031 may be supportable under various rationales,55 the proposed change to a § 1033 standard is hard to justify. Changing standards that would only questionably raise revenue do not have strong theoretical support, and would ignore more than seven decades of successful application of § 1031.

IV. WEAKNESSES IN THE RATIONALES FOR USING A § 1033 STANDARD IN SECTION 1031

A. Questionable Revenue Estimate

The House Report explaining the House bill’s provision for utilizing the § 1033 standard of similar or related in service or use in § 1031 officially indicates that the § 1033 standard better describes a taxpayer who is continuing his or her investment.56 However, as with much recent year-end tax legislation, the genesis of the 1989 House proposal to change to a § 1033 standard does not appear to be a better theoretical justification of continuity of investment in a similar property but rather the hope for revenue. The Joint Committee on Taxation estimated that the proposal of House Ways and Means Committee Chairman Daniel Rostenkowski to limit like-kind exchanges to similar-use property would result in an additional $1.3 billion of tax revenue for the five year period 1990-1994 as follows:57

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<th>Revenue Effect (Fiscal Years, $Millions)</th>
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Chairman Rostenkowski was incorporating the Administration’s proposal. The Administration in turn apparently started from the

54. Id.
55. See infra notes 72-111 and accompanying text.
57. Joint Committee on Taxation, Estimated Budget Effects of Revenue Reconciliation Proposal (July 11, 1989), reprinted in Tax Notes Today (July 12, 1989), 89 TNT 143-9. A number of official pronouncements and commentaries regarding the 1989 proposal are contained in Tax Notes Today (TNT), an electronic data base, and citations are made accordingly.
Treasury Department's list of revenue options which highlighted the restrictions on like-kind exchanges. According to the Joint Committee's revenue estimate, the restrictions on like-kind exchanges would have raised about 6% of the total revenue estimated for the five years from the various proposed changes in the tax law. Of that total, 4% would come from the change to the similar-use standard of § 1033 and about 2% would come from the restriction on related-party basis-shifting.

A number of commentators seriously questioned the government's revenue estimate. The commentators stated that the government's estimate assumed a continued status quo in the volume of exchanges of real property. Most commentators cited their experience with prior proposed or enacted law changes and stated that the volume would not remain the same, but rather severely decline as taxpayers decided not to make exchanges in order to avoid recognition of gain. First Exchange Corporation of Santa Barbara, California, an intermediary engaging in exchanges of real estate for taxpayers seeking to qualify under § 1031, submitted comments on the proposed change to a § 1033 standard. First Exchange calculated that, based on its assumptions, if there were a change in the standard there would be a revenue loss due to the decline in volume of exchanges, rather than a revenue gain.


59. The Joint Committee on Taxation, supra note 57, estimated revenue increases of $1.341 billion over the five-year period 1990-94 from a change to the similar-use standard and $641 million from the restriction on related party basis-shifting. Those two provisions represent 4% and 2% respectively of the total revenue estimate for the five-year period of $31.89 billion.


61. See sources cited supra note 60.

62. See sources cited supra note 60. For an analogous situation involving the decline in capital gains transaction following the 1986 increase in capital gains tax rates, see Dick Armey, The Fast Track to Fiscal Stimulus, WALL ST. J., Apr. 19, 1993, at A16.

63. First Exchange Corporation, supra note 60, at 202-22.

64. Id. The calculations of First Exchange are shown in the Appendix, infra.
It appears that the government's estimate of revenue enhancement is at least questionable. Furthermore, one would hope that tax law changes are made not merely to enhance revenue but for other reasons, such as internal consistency and fairness in the tax law, simplicity, and fostering, possibly, discrete social and economic policies.

B. No Strong Theoretical Justification for Changing Section 1031 Standard to Section 1033 Standard

If a rationale for the change in the standard for exchanged properties under § 1031 is sought for reasons other than mere revenue enhancement, several possible sources for such a rationale exist. First, § 1031 is an exception to the general recognition of gain rule. Second, the other restrictions recently made on § 1031 have been made for various enumerated reasons. Third, the legislative history of § 1031, as well as § 1033, may suggest theoretical justifications for the particular standard of sameness in the properties to be exchanged. Judicial decisions regarding the application of the two statutory sections may favor one or the other for reasons of administrative ease. Finally, the onus may well be on the IRS, since it is seeking to change a relatively successful seven-decade-old standard, to show a strong rationale for a new standard. The rationales favoring § 1031 which emerge from the regulations under I.R.C. § 1002, the legislative history of § 1031 and § 1033, and the judicial treatment of § 1033 are continuity of investment and administrative convenience. Changes enacted in § 1031 have generally been consistent with these rationales and changes not enacted have generally not been so consistent.

1. Section 1031 as an Exception to Recognition of Gain

Section 1031 is contained in Part III, Subchapter O of Title 26. Title 26, of course, contains the Internal Revenue Code. Part III is titled Common Nontaxable Exchanges. In addition to § 1031, it also includes § 1032 regarding exchange of stock for property by a corporation, § 1034 regarding the rollover of gain on sale of a principal residence, § 1036 regarding the exchange of stock for stock of the same corporation, and § 1041 regarding transfers of property between spouses incident to a divorce. These sections are exceptions to § 1001(c) which requires recognition of gain on an exchange to

the extent of the excess of fair market value realized over basis.66 Some explanation of the statutory scheme of exceptions from the general rule of recognition is contained in the regulations under § 1002.67 Section 1002 contained § 1001(c) prior to the 1976 Tax Reform Act.68 The § 1002 regulation was last amended in 1967.69

Treasury Regulation 1.1002-1(c) sets forth the usual rationale of continuity of investment as the reason for not taxing the taxpayer who exchanges property under § 1031.

Exceptions to the general rule are made, for example, by sections 351(a), 354, 361(a), 371(a)(1), 371(b)(1), 721, 1031, 1035 and 1036. These sections describe certain specific exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences are more formal than substantial. As to these, the Code provides that such differences shall not be deemed controlling, and that gain or loss shall not be recognized at the time of the exchange. The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated . . . .70

As can be seen from the regulation, the statutory scheme, at least according to the government in 1967 when the regulation was promulgated, was that § 1031 was an exception to recognition. The similarity in all of these transactions, as emphasized by the regulation, is a continuation of the old investment in the new property.

As previously indicated, the explanation of the House version of the Revenue Reconciliation Act of 1989 indicates that a § 1033 standard is more in accord with the Congressional intent for continuity of investment required by § 1031.71 If the House expression of congressional intent in 1989 is correct, Congress’ intent regarding continuity of investment has changed for the first time in seventy years. The like-kind standard was apparently an expression of that intent since the predecessor to § 1031 was first enacted. Unless some other rationale supports the change in congressional intent, the only rationale that is apparent is the questionable one of raising revenue by the change.

66. Id. § 1001(c); see infra note 70 and accompanying text.
67. Id. § 1002; see also infra note 70 and accompanying text.
69. Levine, supra note 21, at A-1 & n.6.
71. See supra note 56 and accompanying text.
2. **Rationales for Other Changes Made in Section 1031**

   a. **Deferred Exchanges**

   The Tax Reform Act of 1984 added the timing rules of § 1031(a)(3) which apply to deferred, or nonsimultaneous, § 1031 exchanges. As previously indicated, the timing rules require replacement property to be identified within 45 days of transfer of the original property, and to be received within the earlier of 180 days or the due date of the tax return for the year of the transfer. In a deferred exchange, Mr. A gives up his property before Mr. B is ready to supply the replacement property. This type of exchange often occurs with an intermediary to whom A transfers and from whom B receives the property. The intermediary obtains the replacement property, often using dollars already received from B. The use of the intermediary provides Mr. A with some security.

   The 1984 changes were made to help solve the administrative problems present with nonsimultaneous exchanges. These problems include the running of the statute of limitations on the year of transfer of the property when the receipt of property is delayed, the re-determination of basis in new properties received at different times, and the congressional perception that a lengthy delay in an exchange made it resemble a sale followed by a purchase rather than merely a delayed exchange of like-kind properties. Since one of the original rationales for the enactment of the predecessor to § 1031 was administrative inconvenience in attempting to value properties when a like-kind exchange occurred, a consideration of other administrative problems seems an appropriate rationale for the addition of subsection (a)(3) to § 1031. However, as indicated below, a change to a § 1033 standard could not be supported for reasons of administrative convenience because the uncertainty of the § 1033 standard has led to inconsistent litigation.

   Much of the impetus for the 1984 change to § 1031 came from the Ninth Circuit case of *Starker v. United States*, which is read as allowing a deferral for a period ranging from at least five years after

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72. See *infra* notes 39-40 and accompanying text.
73. See *infra* note 38 and accompanying text.
75. See *infra* note 126 and accompanying text.
76. See *infra* note part IV.B.A.
the transfer of like-kind property to possibly even an indefinite future date. Starker opened a number of planning possibilities for clients seeking to defer like-kind exchanges. The government response to Starker was the addition of § 1031(a)(3). On May 16, 1990 and April 24, 1991, the IRS promulgated proposed and final regulations, respectively, on deferred exchanges. In promulgating the proposed regulations, the IRS explained that the regulations clarified issues in deferred exchanges raised by § 1031(a)(3). Apparently most practitioners have agreed with the rationale that the 1984 addition to § 1031 requires clarification.

The final regulations added three major glosses to § 1031(a)(3). First, the regulations limited the alternative properties which could be designated as potential properties to be received in a deferred § 1031 exchange. Second, the regulations clarified the documentation required for identification of the replacement property. Finally, the regulations indicated certain safe harbors for providing security to the party deferring receipt of replacement property so that the party might have security without having constructive receipt of money or other property. Specifically, as to safe harbors, the regulations allowed certain guarantees such as qualified escrows or trusts, qualified intermediaries, and interest or a growth factor.

Judging from the American Bar Association's suggested regulations and the volume of correspondence from practitioners prior to the issuance of the IRS's proposed regulations, a good deal of practitioner support existed for the proposed regulation's imposition of clear-cut restrictions on deferred exchanges. The IRS explained, in promul-
gating the proposed regulations, that the rationales of administrative convenience and continuity of investment were less applicable to deferred exchanges which resembled a sale more than an exchange.88

Of course, aggressive pro-taxpayer arguments can be made against the IRS regulations and rationale. For example, legislative history support for the regulation limiting identification of alternative properties to three properties, or properties totaling 200% of fair market value, might be questioned where regulations are merely needful rather than legislative. Some practitioners have been quite aggressive in structuring exchanges, even following the 1984 change and preceding the proposed regulations.89 However, the IRS’s underlying and often repeated rationale for the enactment of § 1031 and its continued vitality, i.e. administrative convenience and continuity of investment, is now cited by the IRS as the rationale for the new proposed regulations. Therefore, it is hard to justify a change to the § 1033 standard because of the new regulations, given the previously mentioned88 lack of administrative convenience in the definition of the § 1033 similar-use standard.

b. Proposed $100,000 Cap

In 1987, the House version of the Revenue Act of 1987 contained a provision which would have limited the amount of gain a taxpayer could defer on like-kind exchanges of real estate to the amount of $100,000.90 The House Ways and Means Committee Report explained that this provision would promote equity among taxpayers by requiring payment of taxes when income was realized.90


86. 1990-1 C.B. 633, 634.
87. See, e.g., Williamson et al., supra note 44; Wasserman, supra note 60.
88. See supra notes 74-75 and accompanying text.
90. House Ways and Means Committee Report on the revenue provisions that comprise Title X of the Omnibus Budget Reconciliation Bill of 1987, H.R. 3545, as passed by the
However, as at least one commentator pointed out, that House provision would have promoted inequity because of the other provisions of the Code which allowed deferral.\textsuperscript{91} The commentator stated that the rationale was nothing more than an excuse to raise tax revenue.\textsuperscript{92} If the Ways and Means Committee's equity argument were accepted, that argument could similarly support the adoption of the §1033 standard of similar or related in service or use. It is quite difficult to reconcile such an equity argument with the allowance of deferral by other Code sections, particularly when the regulations under §1002 and the legislative history of the predecessor to §1031 indicate that §1031 is part of the package of nonrecognition exceptions to the general recognition rule.\textsuperscript{93}

c. Related Parties

The Revenue Reconciliation Act of 1989 added subsection (f) to §1031.\textsuperscript{94} Subsection (f) requires related parties to recognize gain on a disposition of property if the property was received in a like-kind exchange between the related parties within two years of the disposition.\textsuperscript{95} The gain recognized is that which would have been recognized on the previously qualifying like-kind exchange, but the recognition is in the year of disposition. This change was aimed at preventing basis-shifting among related parties. One commentator explained the process with this example.

\begin{quote}
\textsuperscript{91} Rucker & Williamson, \textit{supra} note 36, at 51 n.14.
\textsuperscript{92} Id.
\textsuperscript{93} Kornhauser, \textit{supra} note 8, at 402.
\textsuperscript{94} I.R.C. § 1031(f) (West 1992).
\textsuperscript{95} This subsection provides:
Special rules for exchanges between related persons.-
(1) In general.—If—
(A) a taxpayer exchanges property with a related person,
(B) there is nonrecognition of gain or loss to the taxpayer under this section with respect to the exchange of such property (determined without regard to this subsection), and
(C) before the date 2 years after the date of the last transfer which was part of such exchange—
(i) the related person disposes of such property, or
(ii) the taxpayer disposes of the property received in the exchange from the related person which was of like kind to the property transferred by the taxpayer,
there shall be no nonrecognition of gain or loss under this section to the taxpayer with respect to such exchange; except that any gain or loss recognized by the taxpayer by reason of this subsection shall be taken into account as of the date on which the disposition referred to in subparagraph (C) occurs.
\end{quote}
\textit{Id.}
For example, consider a taxpayer who owns an apartment house (that he wants to sell) with a fair market value of $100,000 and a basis of $10,000, and his 99% owned partnership, which owns land (that the taxpayer wants to keep) with a fair market value of $100,000 and a basis of $100,000. If the taxpayer sells the apartment house for its fair market value, he would realize a taxable gain of $90,000. If, however, the taxpayer and the partnership exchange the properties, and then the partnership sells the apartment house for its fair market value, the partnership would not realize any gain since the $100,000 received would equal the partnership's $100,000 basis in the exchanged property.

The House explained that the related parties (apparently as a group) had “cashed out” the investment and should not be accorded nonrecognition treatment.

One of the corporate intermediaries engaged in exchanges acknowledged that the related party exchange could be an abuse or misuse which ought to be eliminated. That exchanger distinguished the majority of legitimate § 1031 exchanges. Without a related party, the basis-shifting mechanism will not work unless it is held that the holding by an exchanging taxpayer of multiple properties from which he or she may select a high-basis property for use in an exchange, is a similar abuse. However, such a criticism of the ability to select from multiple properties would attack the very core of the continuity of investment rationale for § 1031. The same commentator indicated that the broader § 1031 standard should be allowed to provide incentive for risk-taking taxpayers to invest in raw land, with the knowledge that they may be able to exchange out of it tax-free if a planned development does not materialize. In fact, even one of the most strongly critical commentators on § 1031 acknowledges that it does provide some incentive to investments.

d. Foreign Property

The Revenue Reconciliation Act of 1989 also added § 1031(h) under which foreign real property and United States real property are not considered like-kind. One pair of commentators indicated

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96. Yurkovic, supra note 60, at 1278.
98. First Exchange Corporation, supra note 60, "Related Party Exchanges."
99. Id.
100. Kornhauser, supra note 8, at 444.
101. I.R.C. § 1031(h) provides: "Special rule for foreign property.-For purposes of this
that, although the legislative history is silent, this change presumably was a specific application of the proposed adoption of the § 1033 standard, because the Conference Committee Report states the exception: United States and foreign realty will be like-kind for § 1033(g) condemnations of real estate.\textsuperscript{102} In addition, a political policy to encourage exchanges and transferability of investment within the United States rather than outside the United States may be at work.\textsuperscript{108} Such a purpose would be in accord with the general § 1031 premise of fostering tax-deferred alienation of property in order to promote the United States economy. The 1989 change, therefore, has been criticized for not allowing a one-way, like-kind exchange of foreign real property into United States real property.\textsuperscript{104}

e. Proposed Holding Period

Besides the House's failure to have the § 1033 standard enacted for § 1031, the House also failed in its attempt to impose an anti-\textit{Bolker}\textsuperscript{106} standard of a one-year holding period for property.\textsuperscript{106} The House proposal would have required that property be held for one year before and after an exchange.\textsuperscript{107} In the Ninth Circuit, \textit{Bolker v. Commissioner} held that the § 1031 requirement, that property be held either for use in a trade or business or for investment, to be satisfied when the taxpayer received the property as a result of liquidation of a corporation and exchanged it shortly thereafter for like-kind property.\textsuperscript{108} The IRS reached the opposite conclusion in a published revenue ruling.\textsuperscript{109}

The House Report on the one-year holding requirement indicated that Congress feared taxpayers might use \textit{Bolker} to support exchanges involving recently acquired property and that a clear-cut rule was needed.\textsuperscript{110} The only holding period actually enacted was the previously discussed two-year holding period regarding like-kind

\textsuperscript{103} \textit{See First Exchange Corporation, supra} note 60, "Foreign Property."
\textsuperscript{104} \textit{Id.}
\textsuperscript{105} Regarding the \textit{Bolker} case, see infra note 108 and accompanying text.
\textsuperscript{107} \textit{Id.}
\textsuperscript{108} Bolker v. Commissioner, 760 F.2d 1039 (9th Cir. 1985).
exchanges between related taxpayers.\textsuperscript{111} Presumably the related party rule reached any abuse perceived by Congress. Without a more specific description of potential abuse to support the one-year rule than that contained in a House Report, there would not seem to be any strong rationale for further restricting \$ 1031's policy of generally favoring alienation of property.

3. \textit{Theoretical Justifications for Section 1031 and Section 1033 in Their Legislative Histories}

Section 1031's standard of like-kind is generally regarded as broader than \$ 1033's standard of similar-use; consequently, the House sought to adopt the narrower standard so as to restrict \$ 1031 exchanges, ostensibly because of a change in congressional intent as to what constituted continuity of investment.\textsuperscript{112} In fact, the \$ 1033 standard is less restrictive in only one instance, at least according to the IRS's ruling position.\textsuperscript{113} The IRS has ruled that improvements on land, when considering the improvements alone and separately from the land, may not be of like-kind with other land but may be similar or related in service or use.\textsuperscript{114}

An examination of the legislative histories of the predecessors of \$ 1031 and \$ 1033, two rather long-standing provisions in the revenue law, does not indicate any strong theoretical policy justifications for favoring the more narrow \$ 1033 standard over the broader \$ 1031 standard. As already suggested, \$ 1031's justification of continuity of investment in order to promote the economy and of administrative convenience favors the broader standard which fosters free alienability with deferral. When subsection (g) was added to \$ 1033 to allow the like-kind standard for condemnations of real estate, the House Report noted, "Moreover, it appears particularly unfortunate that present law requires a closer identity for destroyed and converted property where the exchange is beyond the control of the taxpayer than that which is applied in the case of the voluntary exchange of business property."\textsuperscript{115} The House, however, only extended

\begin{itemize}
\item \textsuperscript{111} See \textit{supra} note 95 and accompanying text.
\item \textsuperscript{114} See \textit{supra} note 4.
\end{itemize}
the § 1031 like-kind standard to condemned real estate. Given the long and apparently successful history of § 1031, the burden to show a strong justification for change should be on those seeking a change in the standard rather than those seeking to continue the status quo.

a. Section 1031 Legislative History

The legislative history of § 1031 and its predecessors indicates that a liberal interpretation of the broad like-kind standard § 1031 was favored on the theoretical grounds of continuity of investment and of administrative convenience. Section 202(c)(1) of the Revenue Act of 1921 is the original predecessor to § 1031. That section provided that no gain or loss was recognized "when any . . . property held for investment, or for productive use in trade or business (not including stock-in-trade or other property held primarily for sale), is exchanged for property of a like-kind or use." The 1921 law changed the 1918 law by providing explicitly for nonrecognition of gain in certain circumstances. The 1918 law, in section 202(b), had provided the general rule of recognition of gain or loss on the exchange of property, to the extent that property was the equivalent of cash because of its fair market value.

The regulations promulgated under § 202(b) in 1919 indicated that an exchange of property was not taxable unless property essentially different had been received so that a change in substance, not merely form, had occurred. In that instance, the transaction could be closed since income was realized. The 1921 Act made three related changes regarding exchanges of property. First, it required that property received have a readily "realizable market value" instead of fair market value. Second, it specified that no recognition occurred unless that standard was met. Third, the 1921 Act added

116. See infra note 139 and accompanying text.
117. For treatments of the legislative history of § 1031, see generally, Kornhauser, supra note 8; Levine, supra note 21; and Comment, Reciprocal Mortgage Sales: A Question of Realization, 41 BAYLOR L. REV. 135 (1989).
119. Id.
120. Id.
122. Id.
123. See supra note 118.
124. See supra note 118.
explicit exceptions to recognition, including both the like-kind exchange rules and the corporate reorganization provisions.\textsuperscript{125} Although the legislative history on this entire package of change in the 1921 law is rather scarce, the history does clearly indicate that the changes were adopted for administrative convenience (because of uncertainty under the 1918 statute), to raise revenue by preventing the taking of colorable losses, and to favor alienability of property so as to allow necessary business adjustments.\textsuperscript{126} It is also clear that a continuity of investment rationale can be inferred from the 1918 law, the 1919 regulation, and the 1921 changes.

In 1924, Congress made two changes to the § 1031 predecessor which clarified the statute and further fostered administrative convenience. First, Congress changed back to the fair market value standard from the readily realizable standard because fair market value was found to be an easier standard to administer.\textsuperscript{127} Second, Congress eliminated the word "use" which was in the 1921 statute. This was because of the confusion "like-kind or use" caused, particularly in instigating the contention that property was divided into two classes which were mutually exclusive: Property could be held either for investment or for productive use in a trade or business.\textsuperscript{128} The 1924 Congress explicitly wanted a broader standard and adopted the statement of Special Assistant to the Secretary of the Treasury A. W. Gregg who stated: "Consequently it is provided in the draft that no gain or loss is realized if the property received is of a like-kind, to be held either for investment or for productive use."\textsuperscript{129} Congress may have foreseen the incipient problems of a use standard which manifested themselves later under § 1033 as discussed below.\textsuperscript{130}

In 1933, a Congressional Subcommittee on Tax Revision recommended the abolition of the exchange and reorganization nonrecognition provisions because of tax avoidance and estimated revenue loss in a fashion reminiscent of both the 1987 proposal to cap defer-

\begin{footnotesize}
\textsuperscript{125} Id. Kornhauser, supra note 8, at 402, discusses the three changes made in 1921.
\textsuperscript{128} See infra note 129.
\textsuperscript{130} See infra note 147 and accompanying text.
\end{footnotesize}
eral at $100,000, and the comments of strong § 1031 critics. However, the Treasury recommended the retention of the exchange and reorganization provisions. Regarding exchanges, the Treasury thought that any revenue gains would be eliminated by additional administrative costs and losses. Congress therefore retained the exchange and reorganization provisions in the 1934 Revenue Act.

The next change to § 1031 was not until the 1984 addition of subsection (a)(3) to § 1031. At the time of that addition, the legislative history clearly indicated that the two reasons for the like-kind provision were administrative convenience and no effective realization. In the interim, the 1967 regulations under § 1002 indicated that § 1031 and the reorganization provisions, as well as the corporate and partnership contribution provisions, were part of a scheme of exceptions to recognition based on continuity of investment.

b. Section 1033 Legislative History

The revenue laws have also contained a predecessor to § 1033 for some seventy years. The Revenue Act of 1921 first added the predecessor. The Treasury had set forth a similar regulation in 1919 under the Revenue Act of 1918. Apparently the impetus for both the regulation and the statutory provision was requisition during World War I, a different circumstance from the administrative and business inconvenience leading to the § 1031 predecessor. It was

131. Compare Rucker & Williamson, supra note 36, at 51 n.14 (criticizing the House's rationale that virtually eliminating § 1031 deferral by imposing a $100,000 cap on gain from real estate would promote equity when other deferral mechanisms remain in the Code) with Kornhauser, supra note 8, at 444-55 (finding inequities in allowing the continued deferral under § 1031 by focusing on taxpayers who are not able to defer by stating that the wealthy benefit primarily from real estate investments, and by questioning the failure to change § 1031 in light of the attack on tax shelters in the 1986 Act). Whether equity or inequity is found, then, appears to turn on the group of taxpayers to whom those benefiting from § 1031 are compared. Because the like-kind exchange provisions are akin to the reorganization provisions as indicated by the legislative history and the Treasury Regulations under § 1002, it seems that, if those engaging in corporate reorganizations are allowed to defer, then those engaging in like-kind exchanges in real estate should also be able to defer.


135. See supra note 70 and accompanying text.


not until 1958 that the § 1033(g) standard of like-kind for condemned real property was first enacted. In 1976, that subsection was amended to allow three years rather than two years for replacement. Apparently the similar-use standard, rather than the like-kind standard, had been used a number of years for property involuntarily converted under § 1033 and its predecessors on the theory that Congress does not allow an involuntary conversion to be the occasion for a broad-based change in type of investment. Congress allows only a deferral of gain where property so taken was replaced with very similar property. A broader standard for § 1031 is intended since Congress affirmatively took a position to ease administrative inconvenience to the IRS and to stimulate the economy, at least by allowing for changes in business investments.

Two pieces of legislative history indicate that Congress viewed § 1033 and its predecessors as distinctly different from § 1031. First, in the previously mentioned 1934 attempt at repeal of the like-kind and reorganization provisions, § 1033's predecessor was not part of the appeal attempt. Second, in a 1950 change to the § 1033 predecessor, a suggestion to broaden the similar or related in service or use standard was rejected because “[t]o permit the taxpayer to defer gain while changing the nature of his investment would be a serious departure from the policy of existing law.”

4. Judicial Treatment of Section 1031 and Section 1033 Standards

Besides a difference in Congressional intent regarding two rather long-standing tax law provisions, there is another reason for not importing the § 1033 standard to § 1031: The § 1033 standard has provided a great deal of uncertainty and resulting litigation in operation. In fact, many of the criticisms of the 1989 House proposal to use the § 1033 standard were based in part on the confusion.

141. See infra note 145 and accompanying text.
142. See infra note 145 and accompanying text.
143. See supra note 126 and accompanying text.
144. See supra note 132 and accompanying text.
146. See infra notes 148-55 and accompanying text.
which that standard had engendered. Under § 1033, the IRS uses a functional use test focusing on the property's physical characteristics or use in other than leased property. Thus the IRS has ruled that a floating seafood processing plant is not similar to a destroyed land-based seafood processing plant under the functional use test.

In the area of leased property, for lessors the IRS uses an investor test and considers the nature of the business risks connected with the property and what the property demands in terms of management and services. Thus the IRS has ruled that a lessor’s leased-out resort hotel destroyed by fire is not similar to a new resort hotel purchased with insurance proceeds and operated by the taxpayer. Like the IRS, the courts have not always been very clear as to where the line between similar and dissimilar is located. However, a leased-out gas station has been held by the IRS to be similar to land and a leased-out warehouse. An apartment building and leased-out filling station or an apartment building and a leased-out office building have been held to be similar by appellate courts. However, an owner-operated motel has been ruled by the IRS not to be similar to an owner-operated mobile home park and two circuit courts have held that an owned and managed hotel is not similar to an owned and managed commercial office building and that an office building is not similar to a drive-in theater and farm. In an attempt to make some sense out of the various IRS rulings and court cases, one leading tax accounting textbook has suggested (and possibly over-simplified) that an owner-user must use the property for the same function (e.g., an occupied office building cannot be replaced with a leased-out office-building) but that an owner-investor only need lease out both rental properties (e.g., office building replaced


149. See sources cited supra note 148.

150. Rev. Rul. 70-399, 70-2 C.B. 164; Rucker & Williamson, supra note 36, at 53 n.35.

151. See sources cited supra note 150.


153. Pohn v. Commissioner, 309 F.2d 427 (7th Cir. 1962); Liant Record, Inc. v. Commissioner, 303 F.2d 326 (2d Cir. 1962).

with apartment building.) Importing this confusion to § 1031 would be directly contrary to the repeated theoretical justification found in the legislative history for § 1031: that administrative convenience was to be fostered.

V. CONCLUSION

Section 1031 should not be changed to use the § 1033 standard of similar-use in order for an exchange of properties to qualify for nonrecognition and deferral. The changes already made to § 1031 have addressed various abuses. The like-kind standard itself does not appear to lend itself to abuse. Rather, Congress would have to indicate, as the House did in 1989, that it was changing its intent on what constituted the appropriate continuity of investment in order to defer recognition. The rationales for the changes do not support using the § 1033 standard. Even the rationale of a huge revenue boost seems to be questionable.

Section 1031 has had a long and relatively undisturbed existence based on the original legislative premises that avoiding recognition eases the government’s administrative burden and burdens on business. There is nothing wrong with § 1031. So why fix it? As stated at the outset of this article, real estate investing has had several restrictions placed on it in recent years. The 1986 Act extended the at-risk rules to real estate, increased depreciation periods for real estate, enacted the passive activity loss rules and repealed capital gains. As several commentators have stressed, to ask the real estate industry to bear another tax increase by way of removing a tax provision is inequitable since other transactions, such as transactions under the corporate reorganization provisions, would still qualify for deferral. However, as one commentator has stressed, those interested in real estate investing ought to remain vigilant since inequity may not prevent Congress from seeking again to change the § 1031 like-kind standard in light of large, though possibly faulty, revenue estimates.

156. See supra note 126 and accompanying text.
157. See generally Yurkovic, supra note 60.
158. Rucker & Williamson, supra note 36, at 51 n.14; Williamson et al., supra note 44, at 13-14 nn.57-59; Investment Realty Company, supra note 60. Some of the commentators also point out the adverse impact on the savings and loan industry if loans for real estate exchanges are curtailed or values must be placed on taxable exchanges in markets where the real estate is overvalued. See, e.g., First Exchange Corporation, supra note 60.
159. Williamson et al., supra note 44, at Conclusion.
One critic of § 1031 stated that we do not need another hero, a premise which is unquestionably accepted.160 Rather than a hero, though, § 1031 has performed as a steady worker over a number of years. The time has not yet come to retire the worker. In fact, the reports of revenue from the worker’s demise may be greatly exaggerated.

160. Kornhauser, supra note 8, at 397.
First Exchange calculated the revenue loss resulting from a change in standard from a § 1031 standard to a § 1033 standard as follows:

I. COMPUTATION 1: Revenue Loss from Proposed Modification of I.R.C. § 1031 Like-Kind Exchanges

A. ASSUMPTIONS

The following assumptions and computations illustrate the potential revenue loss that will be created by the changes to the definition of like-kind property as proposed in the new legislation:

1. 25% of all existing taxable sales of real property involved with exchanges would no longer occur.
2. All exchanges include one taxable sale of real property.
3. 55% of all exchanges would no longer occur.
4. 45% of all exchanges will still be concluded as taxable transactions.
5. The average gain to be realized in each transaction is equal to 35% of the value of the property.
6. The total of all taxable fees, commissions and expenses incurred in connection with each property is 10% of the value of the real property.
7. The total value of all real property involved in exchanges affected by the proposed changes is 10 billion dollars.
8. The marginal tax rate for all taxable events in these transactions is 28%.

B. COMPUTATIONS

Based upon these assumptions, the revenue effect of this proposed change can be computed as follows:

1. Revenue Gain:
   a. Gain in taxable exchange transactions.
   
   \[(\text{Total value of property}) \times (\text{percentage of exchanges that will still occur}) \times (\text{percentage gain in each transaction}) \times (\text{tax rate})\]
   
   Computed as follows:
   
   \[(10 \text{ Billion}) \times (.45) \times (.35) \times (.28) = 441 \text{ Million}\]
b. Total revenue gain: $441 Million

2. Revenue Loss:
   a. Loss of taxable sales transactions (A.1. above).
      \[(\text{Total value of property}) \times (\text{percentage gain in each sale}) \times (\text{percentage of sales lost}) \times (\text{tax rate})\]
      Computed as follows:
      \[(10 \text{ Billion}) \times (.25) \times (.35) \times (.28) = 245 \text{ Million}\]

   b. Loss of taxable expenses (A.6. above) in exchange transactions lost.
      \[(\text{Total value of property}) \times (\text{percentage of exchanges lost}) \times (10\%) \times (\text{tax rate})\]
      Computed as follows:
      \[(10 \text{ Billion}) \times (.55) \times (.10) \times (.28) = 154 \text{ Million}\]

   c. Loss of taxable expenses (A.5. above) in sales lost.
      \[(\text{Total value of property}) \times (\text{percentage of sales lost}) \times (10\%) \times (\text{tax rate})\]
      Computed as follows:
      \[(10 \text{ Billion}) \times (.25) \times (.10) \times (.28) = 70 \text{ Million}\]

   d. Total revenue loss
      (a) 245 Million
      (b) 154 Million
      (c) 70 Million
      Total: 469 Million

OVERALL EFFECT:

TOTAL REVENUE GAIN $441 Million
TOTAL REVENUE LOSS $469 Million
NET GAIN OR (LOSS) ($28 Million)
NET REVENUE LOSS $28 MILLION DOLLARS

II. COMPUTATION 2: Revenue Loss From Proposed Modification of I.R.C. § 1031 Like-Kind Exchanges

A. ASSUMPTIONS

The assumptions are identical to those in Computation 1 except as indicated. The computations utilizing these new assumptions demonstrate an even greater revenue loss that may be created by the
changes proposed in the new legislation:
1. 33.3% of all existing taxable sales of real property involved with exchanges would no longer occur.
2. All exchanges include one taxable sale of real property.
3. 66.7% of all exchanges would no longer occur.
4. 33.3% of all exchanges will still be concluded as taxable transactions.
5. The average gain to be realized in each transaction is equal to 33.3% of the value of the property.
6. The total of all taxable fees, commissions and expenses incurred in connection with each property is 10% of the value of the real property.
7. The total value of all real property involved in exchanges affected by the proposed changes is 10 billion dollars.
8. The marginal tax rate for all taxable events in these transactions is 28%.

B. COMPUTATIONS

Based upon these assumptions, the revenue effect of this proposed change can be computed as follows:
1. Revenue Gain:
   a. Gain in taxable exchange transactions.
      \[(\text{Total value of property}) \times (\text{percentage of exchanges that will still occur}) \times (\text{percentage gain in each transaction}) \times (\text{tax rate})\]
      Computed as follows:
      \[(10 \text{ Billion}) \times (.333) \times (.333) \times (.28) = 310 \text{ Million}\]
   b. Total revenue gain: $310 Million
2. Revenue Loss:
   a. Loss of taxable sales transactions (A.1. above).
      \[(\text{Total value of property}) \times (\text{percentage gain in each sale}) \times (\text{percentage of sales lost}) \times (\text{tax rate})\]
      Computed as follows:
      \[(10 \text{ Billion}) \times (.333) \times (.333) \times (.28) = 310 \text{ Million}\]
   b. Loss of taxable expenses (A.6. above) in exchange transactions lost.
      \[(\text{Total value of property}) \times (\text{percentage of exchanges lost}) \times \]
(10\%) \times \text{(tax rate)}

\text{Computed as follows:}
(10 \text{ Billion}) \times (.667) \times (.10) \times (.28) = 187 \text{ Million}

c. Loss of taxable expenses (A.5. above) in sales lost.
(Total value of property) \times \text{(percentage of sales lost)} \times \text{(10\%)} \times \text{(tax rate)}

\text{Computed as follows:}
(10 \text{ Billion}) \times (.333) \times (.10) \times (.28) = 93 \text{ Million}

d. Total revenue loss
(a) 310 Million
(b) 187 Million
(c) 93 Million
Total 590 Million

OVERALL EFFECT:
TOTAL REVENUE GAIN $310 MILLION
TOTAL REVENUE LOSS $590 MILLION
NET GAIN OR (LOSS) ($280 MILLION)
NET REVENUE LOSS $280 MILLION DOLLARS