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TAX PLANNING ENHANCED BY
TAX-FREE EXCHANGE PROVISIONS

By Thomas R. Frantz

Like-Kind Exchanges

The recent reduction in the effective tax rate applicable to long-term capital gains\(^1\) will inevitably reduce the incentive for tax-free exchanges in those circumstances in which the gain realized is modest and the corresponding tax is relatively minor. Nevertheless, tax-free exchanges will continue as important planning tools in many circumstances, particularly in situations presenting significant gains and those in which a sale of property would otherwise trigger a significant amount of depreciation recapture.

Section 1031 of the Internal Revenue Code is one of several exceptions to the general rule that a taxpayer must recognize gain or loss on the sale or exchange of property. In enacting this provision, Congress intended to avoid (i) the recognition of “theoretical” gains and losses where property received in exchange is substantially a continuation of the taxpayer’s investment in the property transferred, and (ii) the necessity of valuing property in “thousands of horse trades” which occur each year.\(^3\)

Under the provisions of Section 1031, when property held for productive use in a trade or business or for investment is exchanged solely for property of a like kind to be held for either such purpose, no gain or loss is recognized. If an exchange qualifies, the application of the Section is mandatory, and non-recognition of gain or loss will result regardless of a taxpayer’s intent.\(^3\) Because of the mandatory application of the statute together with the fact that few natural situations exist for the reciprocal exchange of like-kind property, the importance of careful planning cannot be understated.

Requirements of Section 1031

Purpose

With respect to the purpose requirement of Section 1031, it is essential that both the property exchanged and the property received be held by the taxpayer “for productive use in trade or business or for

\(^1\) Act Section 402, amending Sections 57(a)(9), 170(e)(1) and 1202, Internal Revenue Code of 1954, as amended (hereinafter cited only by Code section). Generally, the Act reduces the maximum effective rate at which long-term capital gains are taxed from 49.5% to 28%.


\(^3\) U. S. v. Vardine, 305 F.2d 60, 62-2 USTC \#9624 (2nd Cir. 1962). Caveat: a little non-recognition property can cause a large loss to be disallowed. See, e.g., Rev. Rul. 65-155, 1965-1 C.B. 356, where qualifying property constituted only 20% of the property received, whereas non-qualifying property (primarily installment notes) constituted 80% of the property received.
Whether property is held for the proper purposes is a factual determination made with respect to the taxpayer’s intent and the use made of the property at the time of the exchange. For example, the Service in Revenue Ruling 57-244 held that unimproved property qualified as property held for “investment” where the taxpayer’s intent at the time of purchase to construct a residence on it was abandoned in favor of an investment intent. Although the use of the property at the time of the exchange is generally the controlling factor, business property may qualify notwithstanding that it laid idle for a period of time before the exchange or that its business use had been destroyed by circumstances beyond the taxpayer’s control.

Specifically excluded from the definition of “qualifying property” are stock in trade, property held primarily for sale, stocks, bonds, notes, choses in action, certificates of trust or beneficial interest or other securities or evidence of indebtedness or interest. Note that there is omitted from the “property held primarily for sale” exclusion the qualifying language, “to customers in the ordinary course of [a taxpayer’s] trade or business,” of Sections 1221 and 1231. “Primarily” as used in the context of Section 1031 means “of first importance,” so that property may be excluded from its application, notwithstanding that it is not held for sale to customers in the ordinary course of business. Therefore, if the property received in exchange is to be sold, rather than retained for a qualifying purpose, the transaction does not qualify as a like-kind exchange. If property is sold too soon after it is acquired, it will be presumed that the taxpayer’s intent at the time of the acquisition was to sell the property.

The same rule applies where property is exchanged in an otherwise tax-free transfer, too soon after it is acquired, or acquired in an otherwise tax-free manner for the purpose of a qualifying exchange. For example, the acquisition or construction of property for purposes of exchanging it may result in the recognition of any realized gain or loss to the taxpayer acquiring or constructing such property on the grounds that he never held the property for productive use or for investment.

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4 Section 1031(a). Note that the determination of whether property is held for a qualifying purpose is made separately for each party to the exchange, so that one party may qualify for Section 1031 treatment, while the other party may not, Rev. Rul. 66-209, 1966-2 C.B. 299, Rev. Rul. 75-291, 1974-2 C.B. 332.
5 1957-1 C.B. 247.
7 Bernard, 26 TCM 858, T.C. Memo 1967-16. The question of whether property was held “primarily” for sale is one of intent to be determined from all relevant surrounding facts and circumstances. See, e.g., Wm F. Horsting, 5 T.C.M. 421 (1946).
8 Rev. Rul. 75-291, 1975-2 C.B. 332; see also Juhl Smith, 34 TCM 704, T.C. Memo 1975-153 (1975), aff’d 537 F.2d 972 (8th Cir. 1975); see also Century Electric Co. v. Comm’r, 192 F.2d 155, 51-2 USTC ¶ 9482 (8th Cir. 1951), aff’g. 15 TC 581 (1950), cert. den. 342 U.S. 954 (1952).
Further, the Service has denied like-kind exchange treatment to a taxpayer who otherwise completed a qualifying exchange because he immediately transferred the acquired property to a controlled corporation, notwithstanding that the first transfer qualified under Section 1031. Again, the Service's rationale was that the taxpayer failed to hold the property acquired in exchange for a qualifying purpose. Although the ruling is technically correct, the result does not appear to carry out the legislative intent in Sections 1031 and 351, prompting suggestions of legislative action.

Similarly, the Service has held unqualified an exchange in which the taxpayer received property in a distribution from a corporation pursuant to a Section 333 liquidation and immediately exchanged the property for otherwise qualifying like-kind property owned by an unrelated party. According to the Service, the reason for which the distributed property was held by the corporation prior to liquidation could not be attributed to the taxpayer; therefore, he was deemed to have held the property for purposes of exchange rather than for productive use or for investment. Although the rulings clearly indicate the existence of a trap for the unwary, the “trap” may be used to a taxpayer's benefit. A taxpayer apparently may elect whether he desires to recognize a gain or loss on an otherwise qualifying exchange by transferring property to or from a controlled entity, such as a corporation, partnership, trust, etc., immediately before or after an exchange.

Like Kind

In order to qualify for nonrecognition treatment, the property exchanged by a taxpayer must be of “like-kind” to the property received. “Like-kind” refers to the nature or character of property as opposed to its grade or quality and is broadly construed. Thus, all real estate, whether improved or unimproved, qualifies as like-kind since the improvement of such property relates only to its grade or quality.

In determining whether the “nature and character” of property are comparable, consideration must be given to such things as the respective interests in the physical properties, the nature of the title conveyed, the rights of the parties in the property and the duration of the interest.

In structuring a transaction, care must be taken to insure that the “nature and character” of the properties exchanged and received is the same under state law. For example, if under local law mineral interests are regarded as interests in real property, they are considered to be of

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12 Treas. Reg. § 1.1031(a)-1(b).
13 Koch, 71 TC No. 5 (October 23, 1978).
the same nature and character as a fee interest in land and may be exchanged for a fee interest in land. Surprisingly, the Service recently argued, unsuccessfully, that the exchange of fee interests in real estate did not qualify where the property received was subject to a 99-year lease. The property received constituted two separate rights, the Service contended, neither of which qualified as like-kind property with a fee interest in real estate: (1) the right of a reversion at the expiration of the lease having nominal value and (2) the right to an "income stream" represented by rent to be received under the lease. The Tax Court responded that these rights did not, in fact, constitute separate and distinct items of property; rather they were a part of the bundle of rights incident to the ownership of the fee.

There is considerable question whether improvements to property already owned by a taxpayer constitute like-kind property with improved or unimproved real estate. The Service believes they do not and has ruled that the investment of proceeds from an involuntary conversion of land held for investment purposes in the construction of a building, storm drains, a water system and road on land already owned by the taxpayer at the date of the conversion, does not qualify as a like-kind replacement of the converted property within the meaning of Section 1033(g). The Service rationalizes that land, improved or unimproved, is of a different nature or character than improvements on land. Where this has been litigated, however, at least one district court has disagreed with the Service. In Davis v. United States, the Hawaiian District Court refused to follow the Service's position, holding that the investment of the proceeds from the involuntary conversion of unimproved land in the installation of storm drains on land already owned by the taxpayers qualified as a like-kind replacement under Section 1033(g). The court's decision was based on a finding that the improve-

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14 Crichton, 122 F.2d 181, 41-2 USTC ¶ 9638 (8th Cir. 1941), aff'd 42 B.T.A. 490, acq. 1952-1 C.B. 2. See also Wm. Flemming, 24 T.C. 818 (1955), rev'd on other issues, 241 F.2d 78, 57-1 USTC ¶ 9363 (1957) (mineral interests may be exchanged, if the nature and character of the rights conveyed are substantially equal under state law); Rev. Rul. 55-749, 1955-2 C.B. 295 (perpetual water rights are "like kind" with respect to a fee simple interest in land); see, however, M.H.S. Co., Inc. (35 TCM 733 [1976], T.C. Memo 1976-165), aff'd (6th Cir. 1978) (a joint venture was really a partnership under state law; therefore, the taxpayer's interest constituted personal property and the reinvestment of condemnation proceeds did not qualify under Section 1033[g]).

15 Koch, supra, note 13.

16 Revenue Ruling 67-255, 1967-2 C.B. 270. Note that the definition of "like kind" under Section 1033 (g) is the same as its definition under Section 1031. Treas. Reg. § 1.1033(g)-1(a). See also Rev. Rul. 76-390, 1976-2 C.B. 243 (motel constructed on land already owned by taxpayer with condemnation proceeds from land not like kind); Rev. Rul. 76--39, 1976-2 C.B. 243 (commercial building to replace farm land didn't qualify); Letter Ruling 7811056.

17 411 F.Supp. 964, 76-1 USTC ¶ 9418 (D.C. Hawaii 1976), appeal pending to the 9th Circuit.
ments made by the taxpayers represented a substantial continuation of their prior commitment of capital, the underpinning of Section 1031. As a partnership interest is personal property under the laws of all the states, the exchange of real property for an interest in a partnership owning real property does not qualify under Section 1031. Personal property and real property are not of the same nature and character. This presents a “trap” for the unwary in that a joint venture, and in some cases, a tenancy-in-common may constitute a partnership under state law, resulting in the unintended taxation of a taxpayer who exchanges such an interest for real property. However, if a tenancy-in-common does not constitute a partnership interest under state law, the exchange of an interest in such tenancy for a full fee interest in qualifying property will be governed by Section 1031.18

The Service and courts agree that a general partnership interest and a limited partnership interest are not like-kind property.19 They disagree, however, as to whether interests in two general partnerships may constitute like-kind property. In Revenue Ruling 78-135,20 the Service held that a general partnership interest constituted an equity interest coming within the ambit of Section 1031(a)’s parenthetical listing of ineligible property. The Service maintains that its holding is in conformity with Section 741, which requires the transferor-partner to recognize gain or loss on a sale or exchange of a partnership interest. However, the Service’s extension of the parenthetical listing to include equity interests of all types, other than the direct ownership of the underlying property, seems unwarranted and ignores the issues of whether the underlying assets or business of the partnership are of like kind. Further, it fails to mention the cases which have held that the exchange of general partnership interests may qualify under Section 1031 and does not address the question of whether a partnership should be regarded as an aggregate or entity under Section 1031. The Tax Court, in the Estate of Meyer,21 rejected an argument by the Service that general partnership interests were choses in action, specifically excluded under Section 1031[a]; rather, the court extended nonrecognition to the exchange of general partnership interests in different partnerships where both partnerships owned like-kind property.

Exchange

The form in which a transaction is cast is critical, in that an “exchange” must exist. An “exchange” as used in Section 1031(a) is

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18 Rev. Rul. 73-476, 1973-2 C.B. 300. Hence, like-kind exchanges may generally be used to split up investors who hold property as tenants-in-common and who desire to part ways.
19 Estate of Meyer, 58 T.C. 311 (1972), aff’d per curiam, 503 F.2d 556, 74-2 USTC ¶ 9676 (9th Cir. 1974).
defined as a reciprocal transfer of property as opposed to a transfer of property for money consideration, or the right to receive such consideration. Thus, a sale of property, promptly followed by a reinvestment, does not qualify notwithstanding the taxpayer's intent. Note, however, that under Section 1031(b), non-qualifying property, or "boot", may be received or transferred. Although gain realized will be recognized to the extent of boot received, losses are never recognized on qualifying property in transactions falling within Section 1031, notwithstanding the receipt of boot.

Although taxpayers have from time to time encountered difficulties with all the requirements of Section 1031, the "exchange" requirement has undoubtedly created the most problems. A straight "exchange" causes little difficulty. Most of the problems are presented in situations involving delayed exchanges, prior acquisitions of exchange property, multi-party exchanges and in connection with sale-leasebacks. The discussion of these areas of concern will follow a discussion of other general principles.

Boot, Basis, Mortgages and Holding Period

As noted, property qualifying under Section 1031 may be exchanged even though money or other non-qualifying property is received. Where boot is received, however, gain recognized is limited to the amount of money and the fair market value of non-qualified property received. In computing the recognized gain, money paid out in connection with an exchange, such as commissions and closing costs, is offset against boot received and may, to the extent it exceeds the boot, be added in computing the basis of acquired property. The exchange of encumbered property requires careful planning. If the taxpayer transfers encumbered property, whether the liability of the taxpayer is assumed or the property is taken subject to the liability, the taxpayer is considered to have received boot equal to such liability. In the event of reciprocal liabilities, the amount of liability which the taxpayer assumes, or takes the property subject to, is offset against the consideration received in that form; that is, the encumbrances are "netted." In such case, the party exchanging the property subject to the greater liability will recognize the gain to the extent of the difference.

22 See, e.g., Bloomington Coca-Cola Bottling Co. v. Comm'r, 189 F.2d 14, 16, 51-1 USTC ¶ 9320 (7th Cir. 1951).
23 See, e.g., Coastal Terminals, Inc. v. U. S., 320 F.2d 333, 337, 63-2 USTC ¶ 9623 (4th Cir. 1963); Juhl Smith, supra, note 8 (appellate court).
24 § 1031(b); note that if a taxpayer receives some unqualified property in a qualifying exchange, payable in installments (notes), he may elect to report the recognized gain on the installment basis (Section 453) if the transaction otherwise qualified. Rev. Rul. 65-155, 1965-1 C.B. 356.
26 § 1031(d); Treas. Reg. § 1.1031(d)-2.
between the liabilities. Provided, however, that if consideration is given in the form of cash or other property by the taxpayer transferring property subject to the greater liability, such cash or other property given is offset against the difference in mortgages. This, in turn, creates a problem for the taxpayer surrendering the property subject to the lesser mortgage, in that consideration received in other forms, such as cash or other property are treated as boot received for purposes of Section 1031(b) notwithstanding the taxpayer's assumption of liabilities.\textsuperscript{27}

These rules indicate the need for careful planning in order to avoid unintended results. For example, suppose A and B wish to exchange properties, each of which have a basis of $20,000 and a value of $100,000. A's property is encumbered by a $50,000 deed of trust, and B's property is encumbered by a $40,000 deed of trust. The parties contemplate that the properties will be exchanged, subject to the existing deeds of trust, with an appropriate adjustment for the $10,000 difference.

The parties may carry out the transaction in three different ways, each of which result in a different tax treatment. A may pay B the $10,000 in cash; A may prepay $10,000 on his deed of trust note; or B may refinance, borrowing an additional $10,000. If B receives $10,000 cash from A, B will recognize gain to that extent under the rules of Section 1031(b), as the $10,000 cash is not offset by the additional liabilities assumed by B. On the other hand, if B prepays $10,000, neither party will recognize gain on the exchange because the liabilities will be netted. In this regard, B may receive $10,000 in cash, subject to the obligation to apply such payment to a reduction of the liability, thereby becoming a mere conduit for A's prepayment.\textsuperscript{28} Careful drafting, however, is required in such a transaction as B must, in fact, be a mere conduit. Lastly, and perhaps the best alternative if second mortgage money is reasonably priced, is for B to borrow an additional $10,000 to be assumed by A in the transaction. In such circumstances, no gain should be recognized by B.

A taxpayer qualifying for Section 1031 treatment may also recognize taxable income from depreciation recapture. For example, in an exchange of Section 1250 property, a taxpayer will recognize gain to the extent of the greater of the gain recognized on the exchange; or the gain that would normally be determined under the rules of Section 1250, less the fair market value of Section 1250 property acquired in the exchange. The second limitation often causes problems, particularly in connection with the exchange of an improved parcel of real estate for unimproved

\textsuperscript{27} Treas. Reg. § 1.1031(b)-1(c); see Treas. Reg. § 1.1031(d)-2 Ex. (2).

\textsuperscript{28} North Shore Bus Co. v. United States, 143 F.2d 114, 44-1 USTC ¶ 9345 (2d Cir. 1944), aff'd 1 TCM 493; but see Coleman v. United States 180 F.2d 758, 50-1 USTC ¶ 9254 [8th Cir. 1950], aff'd 8 TCM 352 (for the opposite result where B is not a mere "conduit").
The party receiving the land may be subject to significant taxes if the improved parcel has built-in recapture potential. To the extent Section 1250 recapture is not recognized, it is earmarked for future recognition. For this purpose only, the holding period for such recapture commences on the date of the exchange.

Lastly, Section 1031(d) provides that the basis of property received in a qualifying exchange is equal to the adjusted basis of the qualified and non-qualified property transferred, decreased by the amount of any money received and increased by any gain, or decreased by any loss recognized on the exchange. If the taxpayer receives boot in the form of non-qualified property the basis must first be allocated to the boot received, to the extent of its fair market value, and the remainder, if any, to the qualifying property. If more than one qualifying property is received, the total recomputed basis is allocated in proportion to the relative fair market values of such properties.

Although the basis rules are fairly straightforward, there is some room for planning. For example, the requirement that the basis of qualified property received be allocated among such properties in proportion to their relative values may result in higher or lower depreciation deductions due to differing ratios of depreciable versus non-depreciable assets. Further, the useful lives of the exchange property may vary resulting in a more or less rapid write-off.

**Delayed Receipt**

An investor may wish to take advantage of a favorable offer to acquire his property using the like-kind exchange provisions, but may not have located suitable exchange property at the time of closing. In such cases the question arises whether he may deed his property subject to the purchaser's obligation to acquire and convey to him qualifying property in the future. Such a case was recently reviewed by a federal district court.

Though the result has been criticized, an exchange of property for a promise to deliver like-kind property in the future was held by the Oregon District Court in *Starker v. United States* not to qualify for non-recognition treatment under Section 1031. In *Starker*, the taxpayers deeded their property to a purchaser pursuant to an agreement requiring the purchaser to acquire and deed to the taxpayer like-kind property from time-to-time having a total value equal to the agreed value of the property exchanged. The agreement further provided that if similar property having a value equal to the exchange value was not conveyed...
to the taxpayers prior to a certain date, the taxpayers were obligated to accept cash. In the interim, the taxpayers had no control over the cash used by the purchaser to purchase the exchange properties and could not require cash in lieu of property.

In fact, otherwise qualifying properties were transferred to the taxpayers prior to the date on which cash was required to be paid if adequate conveyances were not made. The district court originally held the transaction qualified under Section 1031, but later withdrew its opinion, reversing its prior holding. The court's decision is sketchy and questionable as the taxpayers appear to have complied with the technical requirements of Section 1031 and met its underlying rationale of continuity of investment. Given this adverse precedent, however, taxpayers pursuing a Starker-type factual pattern can expect a challenge. One's exposure to a successful Service challenge can be reduced by structuring a delayed exchange along the lines present in the J. H. Baird Publishing Co. case. In Baird, the Tax Court held that a taxpayer who retained the use of property rent-free after transferring legal title pending the future receipt of qualifying exchange property qualified for Section 1031 treatment under the surrounding facts and circumstances which were found to be consistent with an "exchange." The Service has acquiesced in this decision.

In reviewing the Baird and the Starker decisions, the only apparent distinguishing fact is that the taxpayer in Baird retained possession of the transferred property until the exchange property was deeded to him. The Tax Court characterized this retention as a retention of beneficial ownership, reasoning that the exchange took place not when legal title was conveyed, but when the beneficial ownership was relinquished. It has been suggested that this distinction is without merit, and that the real basis for the Baird decision lies in the application of the step transaction doctrine. If this is correct, the Starker decision should not be followed. Until such time as the matter is clarified, however, a taxpayer who deeds property should retain some of his "bundle of rights" in the property until he receives a conveyance of like-kind property. In the alternative, the taxpayer should structure the transaction as a conditional sale or a lease purchase agreement.

Prior Purchase or Option

The taxpayer must not have already purchased the exchange property. In Juhl Smith, the taxpayer attempted a three-party exchange after he had purchased the exchange parcel (Parcel A). To avoid capital gain on the appreciated like-kind property (Parcel B), he sold Parcel A
to a third party for its purchase price, and then exchanged Parcel A for Parcel B. The Tax Court applied the step transaction doctrine, treating the exchange as a sale. Apparently, the taxpayer did not show that the original purchase of Parcel A was part of an overall plan of exchange. Because the Tax Court left open the question of whether the result would have been different if the taxpayer's original purchase of Parcel A had been pursuant to the same plan as the subsequent exchange, the case has been criticized. However, alternatives exist in the form of three-party exchanges which have been approved by the courts and the Service. Hence, the Smith fact pattern should be avoided.

If a taxpayer holds an option on property a prospective purchaser wishes to acquire, and acquires that property with the proceeds of a loan from the prospective purchaser for the purpose of exchanging the property for like-kind property, the Service may argue that the taxpayer has in substance sold his option. However, the Tax Court has found in such a fact situation that the advance of funds by the prospective purchaser constituted a loan as opposed to "boot," and the transaction qualified as an exchange. Although the Service has acquiesced in the loan treatment, it has not acquiesced in the Court's holding under Section 1031. The Service's position remains that such a transaction constitutes a sale of the option.

Sale-Leasebacks

For bona fide business reasons, or to recognize a loss, a taxpayer may wish to sell his property and simultaneously lease it back for a long term, so as not to be deprived of its use. In the usual case, the taxpayer will receive cash for his property and concurrently enter into a lease with the purchaser. If the sale results in a loss, the Service may argue that the transaction constituted an exchange, particularly if the lease he acquires is for a term of thirty years or longer, including optional renewal periods. Therefore, the Service contends that the taxpayer is not entitled to deduct his loss, and the cash he received for the property is treated as boot.

If the sale of the property is at fair market value, the rental is at the market rate, and bona fide business reasons exist for the sale and the lease-back, however, the separate and independent nature of the

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transactions should be recognized. Although the test requires a factual determination, sale treatment is more difficult to sustain if the lease term, including options, exceeds thirty years. Cases in this area are more difficult to reconcile and are often conflicting. In *Century Electric Co.*, a ninety-five-year lease was held to be part of an exchange, as the Eighth Circuit determined that the position of the taxpayer had not changed in that he had not liquidated his investment. Although there was no finding that the rent or the sales price equaled fair market value, there was some evidence to support the conclusion that the price was less than market.

In *Jordan Marsh Co.*, the Second Circuit held that a sale and lease-back for a term of more than thirty years did not constitute a like-kind exchange. In so holding, the court noted that the business arrangements were reasonable and that non-tax motives existed. The Service, however, considers the transaction a like-kind exchange and will not follow *Marsh*. A similar result was reached by the Third Circuit in *Leslie Co. v. U. S.* In *Leslie*, a taxpayer constructed a building for $3,187,000 and sold it to an unrelated insurance company for $2,400,000, and then leased it back pursuant to a prearranged contract for a term of thirty years, with two ten-year optional renewal periods. Following the transaction, the taxpayer deducted a $787,000 loss on the “sale.” The Tax Court agreed with the taxpayer, holding that the property had been sold. The court based its decision on a finding that the sales price equaled fair market value, even though acquisition and construction costs exceeded $3,000,000, and that the rental paid under the lease was fair rental. Because the court believed that the sales price constituted the fair market value of the property, it determined that no other consideration was paid to the taxpayer.

**Three-Party Exchanges**

Although the theory of multi-party exchanges is not difficult, one must pay meticulous attention to the proper sequence, form and documentation. Generally, these transactions follow one of three formats, all

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38 *Standard Envelope Mfg. Co.* (15 T.C. 41 [1950] acq., 1951-2 C.B. 4), and *May Department Stores, Inc.* (16 T.C. 547 [1951], acq., 1951-2 C.B. 3). See also *Capri, Inc.*, 65 T.C. 162 (the independent significance of a sale and 10-year lease between related entities was recognized where the transaction was for a valid business purpose).

39 *Supra; note 8.*


41 *Caveat*, note that the Court, using a step-transaction analysis, could have found that for a net cost of $787,000 the taxpayer acquired a leasehold interest for 30 years to be amortized over that period. See *Missouri Pacific Railroad Co. v. U. S.*, 104 Ct. Ct. 837-74-1 USTC ¶ 9389 (1973).
of which involve the same scenario. A prospective purchaser (B) wishes to purchase taxpayer’s (A’s) property, but A does not wish to sell because of adverse tax consequences. However, he is willing to trade for property owned by a prospective Seller (C), and C is willing to sell for B’s money. In some cases, a fourth party is used to sell the taxpayer’s property and apply the proceeds to the acquisition of suitable exchange property. If either transaction is properly structured, it will qualify under Section 1031(a). However, the four-party transaction should be avoided if possible because it is more cumbersome and somewhat more dangerous. The Service may argue the fourth party is taxpayer’s agent, and the chances of taxpayer error are greater.

One method of accomplishing a tax-free exchange under such circumstances is for A to convey his property to B, who in turn transfers cash to C, and C transfers his property to A. Under this format, all parties to the transaction must be known at the time of the exchange. Escrow arrangements are usually used, with A and C depositing deeds, and B depositing the money consideration. The Tax Court has approved the use of escrows in such arrangements, and the Service as approved the use of unilateral transfers, notwithstanding the lack of reciprocity between A and C.

In Revenue Ruling 57-244, lots were transferred among three taxpayers with A receiving C’s lot, C receiving B’s lot, and B receiving A’s lot. In holding that the transaction qualified, the Service cited with apparent approval the Fifth Circuit’s decision in *W. D. Haden Co. v. Commissioner*, a four-party exchange. In *Haden* a taxpayer exchanged property with a broker. The broker had purchased the property exchanged for the taxpayer’s property from a third party, with the proceeds of the sale of the taxpayer’s property to a fourth party. The taxpayer was held to have exchanged one property for another, notwithstanding the lack of a reciprocal transfer of property between the taxpayer and the third party. Apparently, all that is now required under Section 1031 is that, as an end result of an agreement, property be received by the taxpayer for the property he transferred.

Under the second format, A and C exchange their properties, followed by B’s purchase of A’s former property from C. Here the Service may argue that C is acting merely as A’s agent for sale, receiving A’s property for delivery to B, and B’s money consideration for purposes of acquiring the property from A. However, as long as C actually takes legal title and beneficial ownership of A’s property,

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43 1957-1 C.B. 247.
44 165 F.2d 588, 48-1 USTC ¶ 9147 (5th Cir. 1948), aff’g in part and rev’g in part 5 T.C.M. 250 (the role of the prospective purchaser may be passive); see *Franklin B. Biggs*, 69 T.C. 905 (1978); *Leslie Q. Coupe*, supra, note 42.
whether for himself or as B's agent, A's exchange qualifies under Section 1031.46

Finally, B may acquire C's property for cash, and then exchange it for A's property. If an exchange is carried out in this manner, the Service may argue that the substance of the transaction is a sale, particularly if B fleetingly holds title. Its argument is that the cash payment to C is in reality the proceeds of A's sale. The courts have approved this format, however, holding it to be immaterial that B acquired title to C's property solely for purposes of the exchange; provided the taxpayer is able to establish that (i) he intended and was obligated only to exchange as opposed to sell; (ii) an exchange actually occurred between A and B; and (iii) B used his funds to acquire C's property temporarily for himself.46

It is somewhat surprising that so many taxpayers have encountered problems with multi-party exchanges, in view of the relatively liberal substantive requirements. For example, three-party exchanges are permitted even if they are structured to reduce taxes. Further, these transactions will not fail to qualify merely because the taxpayer locates the exchange property, carries on all negotiations, pays the closing costs or the purchaser fails to take title, if based on all the facts and circumstances, the taxpayer is able to show the overall plan consisted of interdependent steps to exchange property under Section 1031.47

The sequence, form, and documentation requirements are fairly strict, however, and must be followed with reasonable care in order to ensure qualification.

As indicated, the prospective purchaser may play a relatively passive role in the acquisition of the exchange property from C and the completion of the exchange. None of the courts, however, have gone as far as the recent Tax Court decision in Biggs.48 In Biggs, A orally agreed to sell his Maryland farm to B for $900,000. As part of such consideration A was to receive like-kind property. Later, A located a Virginia farm he wished to receive as exchange property, contracted in his own name to purchase the Virginia property and assigned the contract to, and advanced money to, a corporation controlled by his lawyer to allow the corporation to purchase it. Thereafter, B contracted

45Leslie Q. Coupe, supra, note 42 (comparable four-party exchanges); J. H. Baird Publishing Co., supra, note 34 (property received constructed by C to A's specifications); Mercantile Trust Co. of Baltimore, 32 B.T.A. 82 (1935), acq. XIV-1 C.B. 13 (right to require purchase for cash not exercised).
47Biggs, supra, note 44; Coastal Terminals, Inc., supra, note 23. Cases prior to Biggs have required that in such cases B should pay the purchase price and at least fleetingly assume the risk of ownership. Hubert Rutland, 36 T.C.M. 40, T.C. Memo 1977-8.
48Supra, note 44.
to buy the Virginia farm from the corporation by assuming the deeds of trust thereon, including the deeds of trust securing A's advances. On the following day, A and B entered into a contract under which A agreed to convey the Maryland property to B; and B, in consideration therefor, assigned his right to purchase the Virginia farm to A, and agreed to pay A $900,000 for the Maryland farm. At closing, A conveyed the Maryland farm to B for $900,000 and the corporation conveyed the Virginia farm to A, subject to the deed of trust notes totaling $272,100.

The Tax Court found that under the surrounding circumstances the conveyance of the Maryland farm to B and the acquisition of the Virginia farm from the corporation were interdependent parts of an overall plan, resulting in a qualifying exchange under Section 1031. In so holding, the court focused on the substance of the transaction, taking into consideration all steps in the "integrated plan." It also determined that its result was consonant with the expressed legislative purpose in that the taxpayer had continued his investment. The fact that A received the full purchase price of $900,000 did not alter the tax consequences as the liabilities assumed by A could have been paid by the corporation prior to closing if B would have contributed $272,100 to the capital of the corporation. If the liabilities had been paid, A would have received cash and notes in the amount of $627,900 and the Virginia farm. The Tax Court noted that such a transaction would certainly have qualified under Section 1031 and saw no reason to reach a different result merely because the formal structure of the transaction was different.

Perhaps the strongest pro-taxpayer case prior to Biggs involving a passive purchaser, is the Ninth Circuit's decision in Alderson.46 In Alderson, A executed an agreement with B for the sale of his property to B, who made a deposit toward the purchase price in escrow. After locating suitable exchange property, A and B amended their agreement, under which B, through the escrow agent, was to acquire like-kind property from C and exchange it for A's property in lieu of the cash transaction. B thereafter acquired C's property and exchanged it with A. Prior to B's purchase of C's property, A not only located suitable exchange property, but negotiated its purchase and placed a deposit for it. Further, A contracted for the purchase of C's property under an agreement which clearly provided for the transfer of the exchange property to B. Although the Tax Court determined that the transaction did not qualify under Section 1031, the Ninth Circuit reversed. Apparently the Tax Court held against the Aldersons because they actually executed the purchase agreements for the exchange property. There

46 Supra, note 40; see also Coastal Terminals, Inc., supra, note 26 (§ 1031 treatment sustained, notwithstanding the taxpayer's conveyance of options to purchase the exchange property to B so that the exchange could be completed).
appears to be little to this distinction, however because of the contract's clear provisions that the property be conveyed to B.

The key to a successful multi-party exchange is that the taxpayer must avoid both the receipt of and the right to receive and control cash. Carlton v. United States\(^{60}\) is a classic example of a taxpayer's failing to avoid the receipt of cash. In Carlton, the taxpayer granted a prospective purchaser an option to purchase its property, but retained under the option the right to require the purchaser to acquire other property designated by the taxpayer and exchange such property with the taxpayer in lieu of the required money consideration. Following the purchaser's exercise of the option, the taxpayer located suitable exchange properties and required the purchaser to acquire these properties for the purpose of exchange. The prospective purchaser contracted to purchase the exchange properties. However, instead of complying with the required formalities at closing, under which the transaction would no doubt have qualified, the parties, in order to avoid duplication, did not comply with the required form of the agreement. Rather, the prospective purchaser assigned to the taxpayer its contract to purchase the exchange parcels and paid the taxpayer by check the full amount of the purchase price, with which the taxpayer purchased the exchange property two days later. On the basis that the taxpayer violated the strict prohibition against the receipt of or the right to receive and control cash, the Fifth Circuit held that the transaction failed to qualify under Section 1031, notwithstanding the obvious intent of the taxpayer to execute an exchange. In so holding, the Fifth Circuit distinguished its earlier decision in Haden, noting that the money received by the taxpayer in Carlton was not earmarked for the purchase of the exchange property and thus the taxpayer had unrestricted use of it.

**Involuntary Conversions**

Section 1033 provides for the non-recognition of gain, realized in the event any property is involuntarily or compulsorily converted either directly into property similar or related in service or use, or the proceeds of a conversion are used to purchase such property. Unless the conversion is directly into property similar or related in service or use, the Section applies only to gains and is elective.\(^{51}\) In order to qualify, however, a taxpayer must suffer an event specified in Section 1033(a) or the threat or imminence thereof. Mere reluctance on the part of the taxpayer to dispose of property is not sufficient.\(^{62}\)

With one exception, the replacement property must either be property "similar or related in service or use"\(^{63}\) to the property converted, or stock

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\(^{50}\) 385 F.2d 258, 67-2 USTC ¶ 9625 (5th Cir. 1967).

\(^{51}\) Section 1033(a)(2)(A); see Liant Record, Inc. v. Comm'r, 303 F.2d 326, 62-1 USTC ¶ 9494 (2d Cir. 1962), rev'd and rem'd 36 T.C. 244 (1961).

sufficient to acquire control of a corporation owning qualifying property. Illustrating this, Regulation § 1.1033(a)-2(c)(9) provides that no qualified replacement occurs if the proceeds of unimproved real property taken in condemnation are invested in improved real estate.

Section 1033(g) is the noted exception which allows under certain conditions "real property held for productive use in a trade or business or for investment" to be exchanged or the proceeds to be invested in "like-kind" property. As noted, the like-kind test is the same test as the one applied under Section 1031. Accordingly, the acquisition of controlling interest in stock of a corporation owning "like-kind" property will not qualify.

The proceeds of an involuntary conversion generally must be reinvested within two years after the close of the first taxable year in which any part of the gain is realized. The replacement period is extended to three years for certain conversions of "real property held for productive use in a trade or business or for investment." Further, the Secretary, in either case and upon proper application, may extend the deadline for reinvestment. Likewise, if a taxpayer is able to show reasonable cause for not having filed an application for extension within the specified time period, he may obtain an additional reasonable period after the expiration of the required period.

Very little difficulty is encountered in determining whether property has been stolen or destroyed. Further, a taxpayer who wishes to claim the benefits of Section 1033 has an easier task than a taxpayer who desires to claim a casualty loss as the "suddenness" requirement of Section 165 does not apply. For example, the Service has held that the destruction over a period of years by salt water seepage qualified as an involuntary conversion. Somewhat more difficulty is encountered, however, in showing that property was involuntarily or compulsorily converted as a result of seizure, requisition or condemnation, as the taxpayer must show a "taking" in the strict common law sense; that is, one that is compensable under the United States Constitution. A property interest must be taken or destroyed by a governmental unit for a public purpose. Therefore, a sale by a taxing authority of real estate owned by several individuals as tenants-in-common in order to satisfy a tax lien arising from the failure of one party to pay his proportionate share of taxes on the property does not qualify.

Even more problems are encountered in determining if property is

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53 Section 1033(g) (seizure, requisition, condemnation or threat or imminence thereof).
54 Section 1033(a)(2)(B); proposed Reg. § 1.1033(f).
56 Behr-Manning Corp v. United States, supra, note 52.
converted under the "threat or imminence" of a seizure, requisition or condemnation. The Service's view is that "threat or imminence" exists if the taxpayer has received notification by an authorized public official that a governmental body has decided to acquire his property and if he has reasonable grounds to believe that such taking will occur if he does not voluntarily sell his property. Newspaper stories or a purported quote by a public official that certain property is desirable does not constitute a sufficient threat. Further, a threat to one of two properties is not a sufficient threat to the other unless, perhaps, the properties constitute an economic unit. The courts are somewhat more liberal, however. For example, the District Court for the Eastern District of Virginia has held that a threat exists if a taxpayer reasonably believes that the threat to condemn is present, the authority to condemn exists or is readily obtainable, and the sale is made because of the threat.

Regardless of which test is applied, it is important to document the threat because Section 1033(a)(2)(B) permits a replacement to be made prior to the taking if it occurs after the threat. In such cases, of course, the replacement property must be held by the taxpayer at the time of conversion or sale.

If a governmental authority condemns only a part of a taxpayer's property, he may sell the remainder to a private party and the proceeds of both sales may be reinvested under Section 1031 if the taxpayer is able to show that both parts constitute one economic unit. In order to meet this test, it must be shown that condemnation of a portion of the property rendered it impractical to continue the taxpayer's business on the remainder. In *Harry G. Masser*, a taxpayer owned a freight terminal and vacant lots directly across the street. The lots were used to provide parking space and were a substantial determinant of the profits from the freight terminal business. The taxpayer sold the freight terminal after the lots were condemned because he was unable to obtain replacement lots. The proceeds of the sale and the condemnation of the lots were expended for a similar terminal building and parking facilities in another locale. The Tax Court, in holding that the taxpayer's reinvestment of the combined proceeds qualified under Section 1033, cited the inadequacy of available lots for use in his business, the fact that the lots and terminal were "acquired for the purpose of being used, and were used...as an economic unit" and the apparent fact that the continuation of the business in the terminal without the lots was not practical.

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88 Rev. Rul. 63-221, 1963-2 C.B. 332; Rev. Rul. 74-8 1974-1 C.B. 200 (the sale of property to an agent of a municipality who discloses his principal that has the authority to obtain the power of eminent domain if necessary constitutes an involuntary conversion under § 1033).


The Service, in acquiescing to Masser, established a two-part test. It allows the proceeds from a sale to a private party under such circumstances to be treated as proceeds from an involuntary conversion only if the taxpayer is able to show that the involuntarily converted property can not reasonably or adequately be replaced and the existence of a substantial economic relationship between the condemned property and the other property, so that together they constitute one economic unit. For example, if a portion of a shopping center is involuntarily converted, the Service held in Letter Ruling 7842090, the sale of the remaining portion could not be reinvested under Section 1033 because the property converted could adequately be replaced, and the remainder of the center could be used without the converted portion.

Similar or Related in Service and Use

To determine if property is similar or related in service and use, two tests have generally been applied—"the end use" test and the "same general class" test. The Tax Court, and for a considerable period of time, the Service, applied a strict end use test, regardless of whether the owner of the converted property used it himself or leased it to others. This test requires a comparison of the physical characteristics and the actual end uses of both properties and is often difficult to meet in the case of owner-lesors. With the exception of the Third Circuit, the appellate courts have reversed the Tax Court in the case of owner-lesors, refusing to apply this test on the grounds that it was too strict if the taxpayer was not actually using the property. In such cases the majority of the appellate courts tend to apply a test which requires a determination of the similarities of the lessor's management activities with respect to both properties. The Fourth Circuit applies a more liberal test, however, requiring only that the converted and replacement properties be held for investment by the owners. Finally, in 1964 the Service agreed with a majority of the appellate courts holding that in the case of owner-lesors, the proper test is the similarity in the nature of the owner's relation to the replacement property. Factors taken into account in applying this test include similarity in the extent and type of the owner's management activity, the amount and kind of services rendered to tenants and the nature of the business risks involved. In order to avoid confusion of the tests for lessor-users with that for owner-users, the Service has recently reminded taxpayers that for owner-users the

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64 See, e.g., Liant Record, supra; Clifton Investment Co. v. U. S., 312 F.2d 719 (6th Cir. 1963); see also Filippini v. U. S., 318 F.2d 841, 63-2 USTC ¶ 9548 (9th Cir. 1963) aff'd 200 F.Supp. 286, 62-1 USTC ¶ 9144 (N.D. Cal. 1962) (whether from all the circumstances the taxpayer continued his investment).


end use of the converted property and the replacement property must be similar.\textsuperscript{67}

A taxpayer will be treated as having purchased qualifying property or stock only if the adjusted basis of such property or stock is its cost within the meaning of Section 1012. For example, the purchase of a corporation's stock, which corporation pursuant to a prearranged plan liquidates and distributes to the taxpayer assets comprising property similar or related in service or use, is a qualifying replacement under an extension of the \textit{Kimball Diamond} rationale. Further, the acquisition of the remaining interest in a partnership owning property similar to the involuntarily converted property, making the purchasing partner the sole owner of such property, qualifies under Section 1033.\textsuperscript{68}

\textit{For the Purpose of Replacing the Converted Property}

Except under Section 1033(g), a taxpayer may acquire a controlling interest in a corporation which owns qualifying property, provided the corporation directly owns the replacement property. The statute appears to require that the corporation own the replacement property on the date of acquisition. In \textit{John Richard Corp.},\textsuperscript{69} however, the Tax Court held that Section 1033 applied where the control of a corporation was acquired notwithstanding the fact that the corporation did not own the qualifying replacement property on the date of acquisition. Rather, it subsequently obtained such replacement property. Although the Service originally acquiesced, it withdrew its acquiescence explaining in a later ruling\textsuperscript{70} that it believes the literal wording of Section 1033(a)(2)(A) requires that the corporation own property before or at the time control is acquired.

Notwithstanding the express statutory requirement that property be acquired for the "purpose" of replacing the converted property, courts have tended to overlook a taxpayer's purpose. For example, in \textit{S. H. Kress & Co.}\textsuperscript{71} the Tax Court held immaterial the fact that the taxpayer would have purchased the replacement property even absent the condemnation. In 1976, however, the Tax Court disallowed a replacement for failure to meet the "purpose" requirements. In \textit{Frank G. Templeton},\textsuperscript{72} the taxpayer transferred the proceeds of condemned real estate to a controlled corporation pursuant to Section 351, whereupon

\textsuperscript{67} Rev. Rul. 77-192, 1977-1 C.B. 249.


\textsuperscript{71} 40 T.C. 142 (1963); see also \textit{Smith & Wiggins Gin, Inc.}, 37 T.C. 861 (1962) (replacement property had been ordered as part of overall program prior to destruction or replacement property).

\textsuperscript{72} 67 T.C. 518 (1976), supplementing 66 T.C. 509 (1976).
the corporation used a substantial portion of the funds received from
the taxpayer to purchase other real estate from the shareholder-tax-
payer. The net effect of the transaction was that the taxpayer had a
substantial portion of the money received from the condemnation.
Accordingly, the Tax Court held that he did not acquire the corporate
stock for the purpose of replacing the condemned property. The
Service also argued that the corporation did not own the qualifying
property on the date the shareholder-taxpayer acquired control.

Who May Make a Replacement

Generally, the replacement must be made by the owner of the con-
verted property. Thus, Section 1033 does not apply where property
is converted while owned by a corporation but replaced by its sole
shareholder out of assets distributed to him in complete liquidation.78
Likewise, although there is some authority to the contrary, a partner's
reinvestment of the proceeds of a conversion of partnership property
does not appear to qualify under Section 1033(a).74 An acquiring
corporation in an asset acquisition under Section 381, however, may
make a qualified replacement in the place of the acquired corporation
as, apparently, may the new corporation in a consolidation.76

Perhaps the greatest area of controversy has arisen if the replacement
is made after the death of a person whose property was involuntarily
converted. The Service holds that the purchase or replacement of prop-
erty by a personal representative or heir of a deceased taxpayer whose
property was involuntarily converted during his lifetime, but who died
before replacing same, does not qualify.76 Courts have tended not
to agree with the Service, however, if the personal representative may
be considered to have been acting on behalf of the decedent. For
example, in the Estate of John E. Morris77 the Tax Court allowed
a reinvestment by a personal representative where the decedent had
designed and had substantially begun a plan of replacement and the
personal representative followed that plan in making a replacement.
The rationale in Morris was held to be inapplicable by the Tax Court
where a surviving spouse was found not to be acting on behalf of the
estate of her husband. Accordingly, the Court disallowed her replace-
ment under Section 1033; however, in so holding, it indicated that

75 § 381(c)(13); § 1.381(c)(13)-1(a) to (e); Excelsior-Leader Laundry v. Comm'r, 8 B.T.A. 183 (1927) (nonacq.).
77 55 T.C. 636 (1971); see Estate of Isaac Goodman, 199 F.2d 895, 522 USTC ¶ 9556 (3rd Cir. 1952); see also Rev. Rul. 70-376, 1970-2 C.B. 164 (the grantor
of a grantor trust may make a qualifying replacement following a conversion by the trust); Rev. Rul. 58-407, 1958-2 C.B. 408 (beneficiary of a trust that ter-
minated after a conversion may make a qualifying replacement).
the result might have been different had she purchased the replacement property on behalf of the estate using funds of the estate.\textsuperscript{78}

A different approach was taken recently by an Alabama District Court. In \textit{Chichester v. United States},\textsuperscript{79} the owner of property had properly elected the provisions of Section 1033 following a conversion, but the executor of his estate actually made the replacement when the owner died prior to reinvesting the proceeds. The Court, noting that the Section requires that the "taxpayer" suffering the conversion make the reinvestment, held that "taxpayer" means the person subject to tax. It determined that since the decedent's estate is subject to the tax at his death, it becomes the taxpayer within the meaning of Section 1033(a) and may make a qualifying replacement.

\textbf{Basis and Holding Period}

The basis of property acquired as a result of involuntary conversion is determined by reducing the cost of replacement property by the gain not recognized on the conversion. The holding period rules of Section 1031 are generally applied in Section 1033 transactions. Note in this regard that the exchange of other like-kind property and cash under Section 1031 for the purpose of replacing involuntarily converted property is considered a purchase of replacement property to the extent of the cash under Section 1033.\textsuperscript{80}

\textbf{Other Areas of Concern}

If a taxpayer's property is involuntarily converted and he receives a separately designated severance award for damage to the remaining property, the award is considered to pertain to the remaining property and is applied in reduction of its basis. The taxpayer will, of course, recognize taxable gains to the extent the award exceeds the remaining basis.\textsuperscript{81} In many cases, however, this results in severance damages being received tax-free. Therefore, it is generally advantageous to have as much of an award allocated to severance damages as possible.

Congress has recently legislatively reversed the Supreme Court. In \textit{Central Tablet Manufacturing Co. v. United States},\textsuperscript{82} the Court held that Section 337 non-recognition of gain provisions do not apply to receipts from an involuntary conversion by casualty occurring prior to adoption of a plan of liquidation. Hence, unless the plan of liquidation was adopted before an involuntary conversion, the taxpayer desiring to qualify under Section 337 had to use an alternative route.

\textsuperscript{79} 78-1 USTC ¶ 9458 (N.D. Ala. 1978).
\textsuperscript{81} Rev. Rul. 68-37, 1968-1 C.B. 359.
\textsuperscript{82} 417 U.S. 673, 74-2 USTC ¶ 9511 (1974), aff'g 481 F.2d 954, 73-2 USTC ¶ 9545 (6th Cir. 1973).
Under new Section 1033(f), however, a corporate taxpayer has 60 days following an involuntary conversion in which to adopt a plan of liquidation under Section 337. This provision is effective for involuntary conversions occurring after November 10, 1978.

88 P.L. 95-628 (11/10/78).