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COMMENT

ANALYSIS OF REVENUE RULING 75-292: A PROPOSAL TO ALLOW THE COMBINED USE OF SECTIONS 1031 AND 351 WITHOUT DESTROYING THE TAX-FREE STATUS OF EITHER

Sections 1031¹ and 351² of the Internal Revenue Code of 1954 provide exceptions to the general rule that gain or loss is immediately recognized upon the sale or exchange of property.³ Both sections are premised upon the theory that continuation of an investment in merely a different form is not a taxable event.⁴ Both are mandatory⁵ and provide for the deferment of recognition of gain until a later taxable event occurs.⁶

In Revenue Ruling 75-292,⁷ the Internal Revenue Service⁸ examined sections 1031 and 351 and held that an exchange by a taxpayer of like kind business property immediately followed by a prearranged transfer of the acquired property to his newly created corporation did

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1. INT. REV. CODE OF 1954, § 1031(a), provides in pertinent part:

No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes . . . or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

2. *Id.* § 351(a), provides in pertinent part: "No gain or loss shall be recognized if property is transferred to a corporation . . . by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control . . . of the corporation."

3. *Id.* § 1002, provides: "Except as otherwise provided in this subtitle, on the sale or exchange of property the entire amount of the gain or loss . . . shall be recognized."

4. See notes 79-114 *infra* & accompanying text.

5. *E.g.*, United States v. Vardine, 305 F.2d 60, 66 (2d Cir. 1962) (holding section 1031 mandatory); Gus Russel, Inc., 36 T.C. 965 (1961) (holding section 351 mandatory).

6. When gain or loss is not recognized the transaction is called nontaxable but in reality there is merely a postponement of tax because corresponding adjustments of the Code must be made to the basis of the property received or held by the taxpayer. *E.g.*, INT. REV. CODE OF 1954, §§ 358, 362.

Upon death, however, this deferral effect may become a total exemption because under section 1014 of the Code descendant receives the property with a new basis equal to the fair market value at the time of the inheritance. INT. REV. CODE OF 1954, § 1014.

7. Rev. Rul. 75-292, 1975 INT. REV. BULL. No. 29, at 18.

8. Hereinafter referred to as the Service.

not qualify under section 1031. The reason given for this conclusion was that the taxpayer had acquired the property for transfer to his controlled corporation in exchange for stock rather than to hold for productive use in trade or business or for investment.⁹

Because of the similar underlying legislative policies of both sections,¹⁰ the Service's ruling has provoked charges of literalism and the contention that the phrase "property to be held for productive use in trade or business or for investment" should be construed to embrace property acquired for exchange in a subsequent tax-free transaction.¹¹ The above contention is persuasive, as it would allow a taxpayer to engage in successive bona fide section 1031 exchanges [hereinafter referred to as three-party, two-step exchanges] and still receive tax-free treatment at both stages,¹² a result within the legislative contemplation of section 1031.¹³ Indeed, the reasoning of the revenue ruling, carried to its logical conclusion, would prevent transactions involving the reexchange of like kind property from qualifying under section 1031, for the taxpayer would have acquired the property not to hold for productive business use, or for investment, but for exchange. This result is indefensible as such transactions are closely analogous to simultaneous three-way exchanges permitted by the Service.¹⁴

Thus, it appears that the rationale for denial of section 1031 treatment in a tandem sections 1031-351 transfer is not the one stated, but rather

9. Rev. Rul. 75-292, 1975 INT. REV. BULL. No. 29, at 19.

The application of the Service's reasoning to the reverse situation, in which there occurs an incorporation and a section 351 transfer of property to the corporation followed by a section 1031 exchange between the newly formed corporation and an unrelated corporation, presumably would lead to the same result as that in Revenue Ruling 75-292, because the newly created corporation acquired the property with a view to exchanging, not holding it.

10. See notes 79-104 *infra* & accompanying text.

11. *Literalism Triumphs as IRS Taxes Like-Kind Exchange Followed By Incorporation of Property Received*, 759 CCH REWORD ¶ 8118 at 75338 (1975).

12. For example, when A, B, and C own PA, PB, and PC respectively and engage in the following:

A exchanges PA with B for PB;

A subsequently exchanges PB with C for PC;

A should receive tax-free treatment on both exchanges, despite the fact that A acquired PB solely to exchange it for PC.

13. See notes 79-104 *infra* & accompanying text.

14. A, B, and C effect the exchange by having A transfer his property to B, B then transfers his to C, and C transfers his to A. See Rev. Rul. 57-244, 1957-1 CUM. BULL. 247, discussed at notes 72-77 *infra* & accompanying text; Rev. Rul. 73-476, 1973-2 CUM. BULL. 301.

is that, under the step transaction doctrine,¹⁵ as an end result, like kind property was exchanged for stock, property that expressly is precluded from the definition of like kind.¹⁶ Although premised on the wrong reason, the conclusion of the ruling appears to be correct under the existing statute. It is submitted that, notwithstanding the impermissible end result under section 1031 of receipt of stock, legislative policy, as evinced through the shared legislative history of the two sections, dictates a revision of section 1031 to permit the combined use of sections 1031 and 351.

THE BOUNDARIES OF A PERMISSIBLE SECTION 1031 EXCHANGE

Although no cases have been decided involving successive sections 1031 and 351 exchanges,¹⁷ section 1031 has long been used for three-cornered or multiparty exchanges.¹⁸ In the absence of an applicable statutory definition of "exchange,"¹⁹ several cases²⁰ have established that the word is to be given its ordinary meaning: a transfer of property for property as opposed to a transfer of property for money.

15. See notes 115-32 *infra* & accompanying text.

16. See note 1 *supra*.

17. In *Mays v. Campbell*, 246 F. Supp. 375 (N.D. Tex. 1965), however, the court found an acceptable section 1031 exchange between the taxpayer and a foundation, followed by a sale by the foundation to the taxpayer's controlled corporation. Although the second transfer clearly was not a section 351 exchange in that the transferor was not afterwards in control of the corporation, the decision suggests that a controlled corporation may be added as a third party to the transaction so that the corporation receives a stepped-up basis yet the taxpayer pays no capital gain tax. Dean, *Real Estate: Defining the Outer Limits in a Section 1031 Three-party Exchange*, 28 J. TAXATION 294, 297 (1968).

18. See, e.g., *Mercantile Trust Co.*, 32 B.T.A. 82 (1935), *acquiesced in*, XIV-1 CUM. BULL. 13 (1935) (the first three-party case).

For a thorough discussion of the problems encountered and the form to follow in effective multiparty exchanges, see Cruikshank, *IRS Seeking to Tax Like-Kind Exchanges as Cash Sale and Reinvestment*, 16 J. TAXATION 174 (1962); Dean, *supra* note 17; Gannet, *Sale or Tax-free Exchange? How to Decide What You Want: Tax Planning to Get It*, 30 J. TAXATION 226 (Apr. 1969); West & Chodorow, *New Case Points Up Planning Techniques in Tax-Free Exchanges of Real Estate*, 20 J. TAXATION 52 (1964); Winokur, *Real Estate Exchanges: The Three Cornered Deal*, N.Y.U. 28th INST. ON FED. TAX. 127 (1970); *Three-Party Exchanges: How to Assure Tax Benefit by Careful Planning*, 34 J. TAXATION 58 (Anderson ed. 1971) [hereinafter cited as *Three-Party Exchanges*]; Comment, *Tax Free Exchanges of Real Estate*, 1966 U. ILL. L.F. 466 [hereinafter cited as *Tax Free*].

19. Neither the applicable code section nor regulations provide clarification as to the meaning. See 3 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 20.28 (rev. 1972).

20. See, e.g., *Bloomington Coca-Cola Bottling Co. v. Commissioner*, 189 F.2d 14, 16

The basic premise of section 1031 is that a taxpayer who has arranged a continuation of his investment in like kind property, thus realizing merely a paper profit or loss, should not be taxed.²¹ The courts generally have been liberal in allowing taxpayers to construct these arrangements so as to effectuate an acceptable exchange.²² Under section 1031, the taxpayer can create a trade situation by locating suitable property for a prospective buyer to acquire for exchange.²³ He can enter into negotiations,²⁴ advance money toward the purchase price,²⁵ and even oversee the construction of improvements on the land to be acquired.²⁶ He must not commit himself, however, to purchase the exchange property; rather, he must allow the exchange buyer to actually acquire the property²⁷ in a capacity other than as the agent of the taxpayer.²⁸ If the

(7th Cir. 1951); *Trenton Cotton Oil Co. v. Commissioner*, 147 F.2d 33, 36 (6th Cir. 1945); *Badgett v. United States*, 175 F. Supp. 120, 126 (W.D. Ky. 1959); *Katherine A. Spalding*, 7 B.T.A. 588, 590 (1927).

21. See notes 79-114 *infra* & accompanying text.

22. See, e.g., *Alderson v. Commissioner*, 317 F.2d 790 (9th Cir. 1963); *Century Elec. Co. v. Commissioner*, 192 F.2d 155 (8th Cir. 1951), *cert. denied*, 324 U.S. 954 (1952); *W. D. Haden Co. v. Commissioner*, 165 F.2d 588, 590 (5th Cir. 1948); *Coastal Terminals, Inc. v. United States*, 207 F. Supp. 560 (E.D.S.C. 1962), *aff'd*, 320 F.2d 333 (4th Cir. 1963). But see *John M. Rogers*, 44 T.C. 126, *aff'd per curiam*, 377 F.2d 534 (9th Cir. 1967); *Antone Borcard*, 24 CCH Tax Ct. Mem. 1643 (1965) (court takes a more restrictive view).

One commentator has suggested that this liberal attitude results from judicial recognition that few opportunities arise when two parties desire a reciprocal exchange of like kind property. Note, *Section 1031 Exchange of Like Kind Property: A Court in Trouble*, 22 Sw. L.J. 517, 519 (1968) [hereinafter cited as *Section 1031*].

23. That one party does not have title to the exchange property at the time of the agreement does not deny the benefit of section 1031 to the other party. See Rev. Rul. 75-291, 1975 INT. REV. BULL. No. 29, at 18. See also Dean, *supra* note 17, at 295-96; West & Chodorow, *supra* note 18, at 52; *Three-Party Exchanges*, *supra* note 18, at 59. "In effect, the exchange [in such a case is] between two parties, one of whom had, in his own manner, previously acquired property which was to be subsequently exchanged with that of the taxpayer." *Halpern v. United States*, 286 F. Supp. 255, 258 (N.D. Ga. 1968).

24. See, e.g., *Alderson v. Commissioner*, 317 F.2d 790 (9th Cir. 1963); *Coastal Terminals, Inc. v. United States*, 207 F. Supp. 560 (E.D.S.C. 1962), *aff'd*, 320 F.2d 333 (4th Cir. 1963).

25. See, e.g., *Alderson v. Commissioner*, 317 F.2d 790 (9th Cir. 1963).

26. E.g., *J. H. Baird Publishing Co.*, 39 T.C. 608 (1962) (taxpayer not only supervised construction but approved all invoices before payment).

27. *Carlton v. United States*, 385 F.2d 238 (5th Cir. 1967). In *Carlton*, because the taxpayers took title directly from the owner rather than through the second party, they were held to have sold, not exchanged, their property. Similarly, in *John M. Rogers*, 44 T.C. 126 (1965), *aff'd per curiam*, 377 F.2d 534 (9th Cir. 1967), because the option to buy was exercised prior to the exchange, the taxpayer was held to have sold his property and reinvested in like kind property.

court finds that an agency relationship exists, the taxpayer will be held to have sold the property and to have reinvested the proceeds in like kind property.²⁹ A sale of property, even though immediately followed by a reinvestment in like kind property, is not an exchange under section 1031.³⁰ In such transactions, because the taxpayer has had dominion, albeit momentarily, over "cash," he has "cashed in" on his investment and cannot receive favored treatment, for the requisite continuity of interest is lacking.³¹

The problems involved in three-cornered exchanges under section 1031 therefore are primarily questions of form.³² The intent of the parties to effect an exchange is not controlling in determining whether an exchange in fact has occurred.³³ Although the courts refer to intent,³⁴

28. See, e.g., *Leslie Q. Coupe*, 52 T.C. 394, 406-07 (1969), *acquiesced in*, 1970-1 CUM. BULL. xv.

29. See *Spears & Freedman, Current Planning in Sales and Exchanges of Real Estate*, 1963 So. CALIF. TAX INST. 135. *Spears and Freedman* suggest that the agency issue controls the determination of whether the taxpayer has exchanged or sold his property and repurchased other like kind property. *Id.* at 192, *discussing J. Baird Publishing Co.*, 39 T.C. 608 (1962).

30. See, e.g., *Coastal Terminals, Inc. v. United States*, 320 F.2d 333, 337 (4th Cir. 1963). See also 3 J. MERTENS, *supra* note 19, § 20.28, at 98; *Winokur*, *supra* note 18, at 138-39. During consideration by the House of Representatives of the Revenue Act of 1924 this distinction between a sale and exchange was noted. 65 CONG. REC. 2799 (1924) (remarks of Congressman Green and La Guardia).

31. For a possible exception to this, see *Wright, Multiple-Party, Like-Kind Exchanges*, 56 A.B.A.J. 281 (1970). There the author states that if reinvestment of the cash proceeds in like kind property is required as part of a single transaction, then it is arguable that section 1031 treatment should be available. *Id.* at 282.

Several articles contend that the courts' broad interpretation of what constitutes permissible actions by the taxpayer is equivalent to allowing him to sell and reinvest the proceeds. Consequently, the commentators have espoused a revision of section 1031 to allow, as do sections 1033 (property involuntarily converted) and 1034 (sale or exchange of residence), a sale and reinvestment of the proceeds in like kind property within a specified period of time in order to avoid the economic waste involved in the elaborate schemes devised to effect the form of an exchange. *West & Chodorow*, *supra* note 18, at 55 n.18; *Section 1031*, *supra* note 22, at 524-25, *quoting Spears & Freedman, Current Planning in Sales and Exchanges of Real Estate*, 1963 So. CALIF. TAX INST. 193; *Tax Free*, *supra* note 18, at 473.

32. *Dean*, *supra* note 17, at 296.

33. See, e.g., *Carlton v. United States*, 385 F.2d 238, 243 (5th Cir. 1967); *J. H. Baird Publishing Co.*, 39 T.C. 608, 615 (1962). See also 3 J. MERTENS, *supra* note 19, § 20.14, at 63.

In *Carlton*, though the taxpayers intended from the inception to exchange their property, failure to adhere to the necessary form, by taking the deed directly from the owner-seller rather than through the exchange partner, led the court to hold that they sold the property. *Carlton v. United States*, *supra*.

34. See, e.g., *Coastal Terminals, Inc. v. United States*, 320 F.2d 333 (4th Cir. 1963);

they emphasize the form, looking to whether the deeds were actually exchanged.³⁵ "So long as the formalities of an exchange are observed, [courts seem] willing to find that an exchange has occurred."³⁶ Mere simultaneity of execution is not sufficient;³⁷ the focus is on interdependence between the transfers,³⁸ for if the transaction can be divided into two unrelated transactions, a sale to the taxpayer and a sale by the taxpayer, the desired nonrecognition treatment is lost.

Just as the courts generally are lenient in allowing taxpayers to engineer multiparty transactions to achieve the requisite form of an exchange, so too the interpretation of what qualifies as like kind property is broad.³⁹ All real estate is of like kind;⁴⁰ even an exchange of a leasehold of over thirty years for a fee interest is a like kind exchange.⁴¹ Because section 1031 was enacted to remove any economic barriers that might inhibit the improvement of a taxpayer's business or investment holdings,⁴² to avoid taxation of a "paper gain which [is] still tied up in

James Alderson, 38 T.C. 215 (1962), *rev'd*, 317 F.2d 790 (9th Cir. 1963).

35. See, e.g., *Boise Cascade Corp.*, 33 CCH Tax Ct. Mem. 1443, 1448 (1974), *quoting* *Leslie Q. Coupe*, 52 T.C. 394, 405 (1969).

36. Winokur, *supra* note 18, at 142. The Internal Revenue Service does not accept that view. *Id.* Winokur contends that "there seems to be an ever increasing reliance on the final form of the actual transaction . . . [which] could mean ultimately that the only requirement for a tax-free exchange will be an exchange of deeds when the transaction is finally consummated." *Id.* at 143.

37. *Halpern v. United States*, 286 F. Supp. 255, 258 (N.D. Ga. 1968).

38. E.g., *Redwing Carriers, Inc. v. Tomlinson*, 399 F.2d 652 (5th Cir. 1968) (purchase of new trucks followed by a sale of used trucks found to be a trade-in and therefore a section 1031 exchange despite the structure of the transaction); *Allegheny County Auto Mart, Inc. v. Commissioner*, 208 F.2d 693 (3d Cir. 1953) (*per curiam*) (simultaneous sale and purchase of lots held to be an exchange because they were "inseparable" transactions); see discussion of the step transaction doctrine at notes 115-132 *infra* & accompanying text.

39. Treas. Reg. § 1.1031(a)-1(b), T.D. 6935, 1967-2 CUM. BULL. 275, provides in pertinent part: "As used in section 1031(a), the words 'like kind' [refer] to the nature or character of the property and not to its grade or quality. . . . The fact that any real estate involved is improved or unimproved is not material. . . ."

40. 3 J. MERTENS, *supra* note 19, § 20.28, at 100.

41. Treas. Reg. § 1.1031(a)-1(c), T.D. 6935, 1967-2 CUM. BULL. 275. The validity of this conclusion was questioned in *Masill, Notes on the Revenue Act of 1924—Income Tax Provisions*, 24 COLUM. L. REV. 836, 842 (1924), but was accepted in *Century Elec. Co. v. Commissioner*, 192 F.2d 155 (8th Cir. 1951), *cert. denied*, 324 U.S. 954 (1952). A bona fide sale of a fee with a simultaneous leaseback of 21 years was held not to be a like kind exchange in *City Investing Co.*, 38 T.C. 1 (1962).

42. Section 1031, *supra* note 22, at 524. See also notes 79-114 *infra* & accompanying text.

a continuing investment of the same sort,"⁴³ the focus in defining "like kind" is on whether the taxpayer received something substantially different from what he had before the exchange. The dispositive question, therefore, is whether there is a taxable change in "nature or character" (a change in substance) as opposed to a nontaxable change in "grade or quality" (a change merely of form).⁴⁴

Acknowledging the legislative intent not to tax mere changes in the form of investment, the cases have upheld a broad interpretation of "like kind."⁴⁵ Allowing an expansion of the meaning of "held" and "to be held" to include acquiring property for a subsequent tax-free exchange of like kind property would similarly be consistent with the statutory purpose of section 1031.⁴⁶ The taxpayer in such situations, unlike one who seeks only to dispose of the property acquired to liquidate his holdings, meets "[t]he underlying assumption of [the exceptions in section 1031]: that the new property is substantially a continuation of the old investment still unliquidated."⁴⁷

Several cases⁴⁸ have discussed the distinction between property held "primarily for sale"⁴⁹ (property expressly excluded from section 1031 treatment), and "property held for productive use in trade or business or for investment."⁵⁰ Although a mere willingness to sell does not con-

43. *Jordan Marsh Co. v. Commissioner*, 269 F.2d 453, 456 (2d Cir. 1959).

44. *Treas. Reg.* 1.1031(a)-1(b), T.D. 6935, 1967-2 CUM. BULL. 275.

45. *See, e.g., Century Elec. Co. v. Commissioner*, 192 F.2d 155 (8th Cir. 1951), *cert. denied*, 324 U.S. 954 (1952).

46. Arguably the property acquired for exchange is being held for productive use in trade or business in that it is the means through which the business or individual acquires other like kind property. In other words, might it not be characterized as investment or productive business property because it is the intervening step that effectuates a like kind exchange?

47. *Ethel Black*, 35 T.C. 90, 94 (1960), *quoting* *Treas. Reg.* 1.1002-1(c) (1960).

48. *See, e.g., Wineberg v. Commissioner*, 326 F.2d 157 (9th Cir. 1963); *Regals Realty Co. v. Commissioner*, 127 F.2d 931 (2d Cir. 1942); *Burkhard Inv. Co. v. United States*, 22 F. Supp. 23 (S.D. Cal.), *aff'd*, 100 F.2d 642 (9th Cir. 1938); *Harr v. MacLaughlin*, 15 F. Supp. 1004 (E.D. Pa. 1936); *S. H. Klarkowski*, 34 CCH Tax Ct. Mem. 1827 (1965), *aff'd*, 385 F.2d 398 (7th Cir. 1967).

49. Whether property is held "primarily for sale" is entirely a question of fact that requires an investigation of all circumstances and activities. *George M. Bernard*, 26 CCH Tax Ct. Mem. 858, 863 (1967). The word "primarily" means "of first importance" or "principally." *Id.*, *citing* *Malat v. Riddell*, 383 U.S. 569, 572 (1966) (per curiam) (though *Malat* examined another section of the Internal Revenue Code, the *Bernard* court found its rationale applicable to section 1031(a)).

50. No cases, however, have examined the issue of whether property acquired with a view to transferring it to a controlled corporation in exchange for stock or to reexchang-

clusively preclude nonrecognition,⁵¹ in those cases in which the taxpayer was denied section 1031 treatment, the property was acquired with an intent to resell.⁵² The requisite continuity of interest was lacking, and the express words of the statute therefore affronted.⁵³ In so concluding, the courts in these cases did not focus on the length of holding time; this factor may be significant, but it is not conclusive in determining the taxpayer's purpose. Rather, the courts focused on the economic realities surrounding the acquisition and disposal of the property.⁵⁴

In *Regals Realty Co. v. Commissioner*,⁵⁵ for example, a corporate taxpayer chose to exchange, rather than sell, some business real estate to avoid paying capital gains tax. Approximately one month after the exchange, a directors' vote to sell the acquired realty to effectuate a complete liquidation compelled the court to decide the property was held primarily for sale.⁵⁶ The Tax Court in *Ethel Black*⁵⁷ reached the

ing it for other like kind property is acceptable section 1031 property. For a discussion of the extreme difficulty of making this distinction, see 3 J. MERTENS, *supra* note 19, § 20.27, at 97.

51. In *Burkhard Inv. Co. v. United States*, 100 F.2d 642, 646 (9th Cir. 1938), *quoting* *Loughborough Dev. Corp.*, 29 B.T.A. 95, 99 (1933), property was declared held for investment "although such property may have been acquired with the intention of selling or disposing of the same at some subsequent, though not early, date. . . ."

52. *See, e.g.*, *Brooks Griffin*, 49 T.C. 253, 260 (1967) (a prearranged subsequent sale foreclosed section 1031 treatment).

53. *See, e.g.*, *Regals Realty Co. v. Commissioner*, 127 F.2d 931 (2d Cir. 1942); *Harr v. MacLaughlin*, 15 F. Supp. 1004 (E.D. Pa. 1936); *S. H. Klarkowski*, 34 CCH Tax Ct. Mem. 827 (1965), *aff'd*, 385 F.2d 398 (7th Cir. 1967). *Compare* *Brooks Griffin*, 49 T.C. 253 (1957) (lack of continuity of interest existed because taxpayer arranged sale of property he was to receive prior to the exchange) *with* *Rev. Bul. 75-292*, 1975 INT. REV. BULL. No. 29, at 18 (continuity of ownership existed as facts involved no prearranged subsequent liquidation, but only a planned change in proprietary form from individual to corporate ownership).

54. *See, e.g.*, *Wineberg v. Commissioner*, 326 F.2d 157, 163 & n.6 (9th Cir. 1963) (timberland held an average of eight years found to be property "held primarily for sale"); *B. B. Margolis*, 31 P-H Tax Ct. Mem. ¶ 62,086, at 521 (1962) (lots held "many" years does not establish an intention to hold them for investment). Economic realities also have prompted courts to conclude that property was held for investment. *See, e.g.*, *Burkhard Inv. Co. v. United States*, 22 F. Supp. 23, 24-5 (S.D. Cal.), *aff'd*, 100 F.2d 642 (9th Cir. 1938) (land acquired with the belief that it would appreciate concomitant with the development of the surrounding area found to be property held for investment); *Loughborough Dev. Corp.*, 29 B.T.A. 95, 96-8 (1932) (land acquired with the view that it would appreciate concomitant with the growth of a city found to be property held for investment).

55. 127 F.2d 931 (2d Cir. 1942).

56. *Id.* at 933.

57. 35 T.C. 90 (1960).

same conclusion when the taxpayer retained the acquired property solely for the purpose of making improvements for resale.⁵⁸

After analyzing the economic realities of the exchange in *George M. Bernard*,⁵⁹ the Tax Court rejected the taxpayers' assertion that the land was acquired for farming,⁶⁰ and concluded that it was acquired merely because it was more readily marketable. The court noted that the acquired land was smaller than the land for which it was exchanged, was separated from the taxpayers' other farm land by a considerable distance, and was suitable not for farming but rather for subdivision.⁶¹ The court, therefore, looked to the taxpayers' ostensible productive use of the exchanged property in holding that "token farming" was incidental to their primary concern of liquidating all of their property interests in the area. This same practical approach was used in *S. H. Klarkowski*,⁶² in which the court decided that a tract of land retained for six years was held primarily for sale.⁶³ The court determined pragmatically that the taxpayer would not have exchanged improved income-producing land for non-income-producing land unless he planned to resell the property received so as to liquidate his investment. Thus, the courts, in denying section 1031 treatment, have emphasized the taxpayer's intent to liquidate his holdings rather than the length of time the property was held.

In marked contrast to these cases, the facts of Revenue Ruling 75-292⁶⁴ involve no liquidation of the taxpayer's investment. To the contrary, the property acquired in the section 1031 exchange⁶⁵ was reexchanged immediately to enable the taxpayer to expand and continue, *not to termi-*

58. *Id.* at 92, 95.

59. 26 CCH Tax Ct. Mem. 858 (1967).

60. *Id.* at 864.

61. *Id.*

62. 34 CCH Tax Ct. Mem. 1827 (1965), *aff'd*, 385 F.2d 398 (7th Cir. 1967).

63. 34 CCH Tax Ct. Mem. at 1843.

64. 1975 INT. REV. BULL. No. 29, at 18.

65. Revenue Ruling 75-292 examines the nature of the taxpayer's holding after the exchange. *Id.* A related revenue ruling, Rev. Rul. 75-291, 1975 INT. REV. BULL. No. 29, at 18, focuses on the nature of the holding *prior* to the exchange. In Revenue Ruling 75-291, the taxpayer acquired property *by purchase* immediately prior to the exchange of like kind property. He therefore was said to be ineligible for nonrecognition of gain because he had not held the property for productive use in trade or business. *Id.* This situation can be distinguished from the facts in Revenue Ruling 75-292 in that the taxpayer did not exchange section 1031 property he had *been* holding but bought the property to effect the exchange. The necessary continuity of interest was therefore absent.

nate, his business in merely a different form.⁶⁶ Ultimately, however, through the subsequent section 351 exchange, the taxpayer received stock, property expressly precluded from the definition of "like kind."⁶⁷ Therefore, under the existing statute, although the requisite continuity of interest exists, the transaction is ineligible for section 1031 nonrecognition treatment.⁶⁸ In other transactions involving a three-party, two-step exchange⁶⁹ with successive section 1031 transfers, however, not only does the taxpayer's interest remain unliquidated, but no property precluded by the statute is received or given. Additionally, the sole reason the property is held only briefly is so that the taxpayer may engage in another like kind exchange. Without the intervention of impermissible property, the taxpayer has upgraded his holdings while continuing his previous investment in a different form. Also, as required, the form of an exchange has been adhered to, with the taxpayer holding like kind property throughout the transaction.⁷⁰ Clearly, such an exchange is within the legislative contemplation of section 1031⁷¹ and favored treatment should be awarded at both stages.

Further support of this contention is found in Revenue Ruling 57-244,⁷² in which a taxpayer was allowed section 1031 treatment in a three-way exchange even though after the exchange he sold the acquired property to another individual.⁷³ The taxpayer's subsequent sale, though possibly not prearranged, must have been close enough in time to have been considered within the *res gestae* of the transaction. Nevertheless, the sale did not eliminate nonrecognition treatment for the taxpayer. This ruling contradicts, and thus weakens, the Service's argument that acquisition of property with a view to exchanging it does not meet the statutory purpose of section 1031, in that the Service validated in Revenue Ruling 57-244 an exchange of like kind property not acquired for investment or productive use in trade or business.

66. The taxpayer had incorporated his sole proprietorship. Rev. Rul 75-292, 1975 INT. REV. BULL. No. 29, at 18.

67. INT. REV. CODE OF 1954, § 1031(a).

68. The section 351 transfer is not affected by the inapplicability of section 1031 to the prior exchange and is still a valid tax-free exchange.

69. For a description of a three-party, two-step exchange, see note 12 *supra*.

70. See notes 17-38 *supra* & accompanying text in which the requirements as to the form of an exchange under section 1031 are discussed.

71. See notes 79-114 *infra* & accompanying text.

72. 1957-1 CUM. BULL. 247.

73. *Id.* But see cases discussed in text accompanying notes 55-63.

Revenue Ruling 57-244, as well as the more recent Revenue Ruling 73-476,⁷⁴ expressly held that three-way transfers constitute tax-free exchanges under section 1031. In the earlier ruling, three taxpayers jointly acquired undeveloped acreage which they divided into three lots. After holding the land for five years for investment purposes, the taxpayers exchanged lots in a three-way transaction; the exchanges were upheld as within the meaning of section 1031.⁷⁵ In a slightly different factual setting, Revenue Ruling 73-476 also upheld the validity of three-way transactions under section 1031. In that ruling, three taxpayers who owned undivided interests in three separate parcels of real estate as tenants in common, exchanged their undivided interests in the three properties for the complete ownership of one parcel.⁷⁶

Although these three-way exchanges differ from three-party, two-step exchanges in that in the former there is no intermediary exchange involving the reexchange of like kind property,⁷⁷ the two types of exchanges are so closely analogous as to dictate identical treatment for both. Yet, if the reasoning used by the Service in Revenue Ruling 75-292 is applied to successive like kind exchanges, the party who reexchanges property will be denied section 1031 treatment at both stages because he acquired the property with a view to exchanging, not holding, it. This disturbing result leads to the conclusion that the Service's analysis was incorrect, for as the legislative history of the section⁷⁸ reveals, successive section 1031 exchanges are desirable and are justified by tax policy.

74. 1973-1 CUM. BULL. 301.

75. 1957-1 CUM. BULL. 247.

76. 1972-2 CUM. BULL. 301.

77. The intermediate step in a three-party, two-step exchange occurs when the taxpayer acquires property by exchange for subsequent reexchange. For example, if A owns PA, B owns PB, and C owns PC and A desires PC but C will accept only PB in exchange, then A's desire may be effectuated by the following three-party, two-step exchange:

A exchanges PA with B for PB.

A exchanges PB with C for PC.

A's exchange of PA for PB constitutes the intermediate step. (It is intermediate in the sense that it falls between A's ownership of PA and PC.) Obviously, such a step is lacking in a three-way exchange because in that type of transaction, A would not acquire property to reexchange it for other property; rather a simultaneous exchange by A, B, and C would occur. See note 14 *supra*.

78. See notes 79-114 *infra* & accompanying text.

THE COMMON UNDERLYING PURPOSES OF SECTIONS
1031 AND 351 AS EVINCED THROUGH THEIR
LEGISLATIVE HISTORIES

As stated in the treasury regulations, because both sections 1031 and 351 are exceptions to the general rule of recognition of gain and loss, they are construed strictly⁷⁹ and "do not extend either beyond the words or the underlying assumptions and purposes of the exception."⁸⁰ The regulations further explain that "[t]he underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated. . . ." ⁸¹ This administrative interpretation of the basic policy of the sections as corroborated through an examination of their legislative histories, reveals that the provisions are based on the premise that like kind exchanges under section 1031, and transfer of property to a controlled corporation under section 351, are mere changes in the form of investment and thus are not taxable events.⁸²

Although as early as 1918 various exchanges of property between taxpayers were exempt from the general rule of recognizing gain or loss,⁸³ the basic principle that mere changes in the form of investment should not be taxed was not given statutory recognition until the Revenue Act of 1921.⁸⁴ Significantly, in the 1921 Act the predecessor to both sections 1031 and 351 was a single section;⁸⁵ that section transformed the pre-

79. Treas. Reg. 1.1002-1(b) (1960).

80. *Id.* See also George M. Bernard, 26 CCH Tax Ct. Mem. 858, 863 (1967), *quoting in part*, Treas. Reg. 1.1002-1(b) (1960); Ethel Black, 35 T.C. 90, 94 (1960), *quoting in part*, Treas. Reg. 1.1002-1(b) (1960).

81. Treas. Reg. 1.1002-1(c) (1960).

82. See *Carlton v. United States*, 385 F.2d 238, 241 (5th Cir. 1967) (discussing section 1031); B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* 3-4 (3d abr. student ed. 1971) (discussing section 351).

83. Section 202(b) of the Revenue Act of 1918, Ch. 18, 40 Stat. 1060, required that gain be taxed or loss be deducted in any exchange of property other than an exchange of stock pursuant to a reorganization plan. Moreover, a treasury regulation under the Act, Reg. 45 Art. 1563, provided that no gain or loss was recognized from acquisition and subsequent disposition unless a change in substance and not merely form occurred. Wright, *Multiple-Party, Like-Kind Exchanges*, 56 A.B.A.J. 281, 281 & n.7 (1970). For an explanation of the problems encountered under section 202(b) of the 1918 Act, see 64 CONG. REC. 2851 (1923) (remarks of Congressman Green). Congressman Green stated: "The result of this provision was both injurious to the Treasury and to the transaction of ordinary business."

84. Ch. 136, § 202, 42 stat. 230.

85. Revenue Act of 1921, ch. 136, § 202(c)(1), 42 Stat. 230 (now INT. REV. CODE OF 1954, § 1031); Revenue Act of 1921, ch. 136, § 202(c)(3), 42 Stat. 230 (now INT. REV. CODE OF 1954, § 351). This close proximity of the two provisions, representative of their

sumption of taxability in exchanges of property to one of nontaxability⁸⁶ and provided new rules of nonrecognition "for those exchanges or 'trades' in which, although a technical 'gain' may be realized . . . the taxpayer actually realizes no cash profit."⁸⁷ Congress' aim was to disregard merely formal dispositions that lacked economic or commercial reality⁸⁸ and thereby facilitate necessary business readjustments.⁸⁹ By thus eliminating the tax consequences, the provision removed any inhibitions the taxpayer might have about incorporating⁹⁰ or upgrading his holdings for productive use or for investment.⁹¹

common purpose, continued until the adoption of the Internal Revenue Code of 1954. See, e.g., INT. REV. CODE OF 1939, ch.1, §§ 112(b)(1), (5), 53 Stat. 37; Revenue Act of 1938, ch. 289, §§ 112(b)(1), (5), 52 Stat. 485; Revenue Act of 1934, ch. 277, §§ 112(b)(1), (5), 48 Stat. 704; Revenue Act of 1932, ch. 209, §§ 112(b)(1), (5), 47 Stat. 196; Revenue Act of 1928, ch. 852, §§ 112(b)(1), (5), 45 Stat. 816-17; Revenue Act of 1926, ch. 27, §§ 203(b)(1), (4), 44 Stat. 12; Revenue Act of 1924, ch. 234, §§ 203(b)(1), (4), 43 Stat. 256.

86. S. REP. NO. 275, 67th Cong., 1st Sess. 11 (1921) [hereinafter cited as S. REP. NO. 275]. In discussing section 202(d) of the 1921 Act, Congressman Hawley stated that "[t]he amendment liberalizes the law in the interest of the taxpayer . . . [and] also relieves such a transaction from delay, simplifies the tax return, and *promotes* such exchanges of property." 61 CONG. REC. 5201 (1921) (emphasis supplied).

87. S. REP. NO. 275, *supra* note 86, at 11.

88. See *Hearings (Confidential) Explanation of 202(c) Before the Senate Finance Committee*, 67th Cong., 1st Sess. 27, 30 (1921). Dr. Adams of the Treasury Department, commenting upon transfer of appreciated property to a newly created corporation (as is the case in Revenue Ruling 75-292) in exchange for all its stock, stated: "I can not believe that there is enough difference in the ownership of the property and the stock under such circumstances to justify us in recognizing taxable gain or deductible loss." *Id.* at 30. During these hearings taxes upon such a transaction were described as a "clog upon enterprise" because "[t]here has really been no profit made. It is just a change in the kind and character of title to the property. . . ." *Id.* (remarks of Senator Simmons).

89. *Id.* at 30. See also H.R. REP. NO. 350, 67th Cong., 1st Sess. (1921), *reprinted in* 1939-1 CUM. BULL. pt. 2, at 175, 176; 64 CONG. REC. 2855 (1923) (remarks of Congressman Green). In explaining the revision of the Act of 1921, Congressman Green stated that the purposes of the revisions had been to facilitate business transactions. *Id.*

90. Note, *Section 351 of the Internal Revenue Code and "Mid-Stream" Incorporations*, 38 U. CIN. L. REV. 96, 106-07 (1969).

91. S. REP. NO. 275, *supra* note 86, at 11. Because of the liberal provision of the 1921 Act, taxpayers who owned appreciated investment securities were able without recognition of gain to exchange these for new securities. H.R. REP. NO. 1432, 67th Cong., 4th Sess. 1, 2 (1923) (letter of Andrew Mellon, Secretary of the Treasury). Because of the resulting severe tax avoidance, *id.*, see also 3 J. MERTENS, *supra* note 19, § 20.22, at 80, in the Act of March 4, 1923, ch. 294, § 202(c)(1), 42 Stat. 1560, the parenthetical phrase in section 202(c)(1), excluding certain property from nonrecognition status, was expanded to encompass stock, bonds, notes and other evidences of ownership. Significantly, the reason for excepting such stock for stock exchanges

The congressional reports⁹² explaining the amendments in the Revenue Act of 1924⁹³ reiterate the policy espoused for both sections throughout their legislative histories, that the transactions covered involve no substantial change in ownership and thus are not to be taxed until gain is realized by a sale or an exchange that is the equivalent of a sale.⁹⁴ Similarly, this same principle recurs throughout the congressional hearings,⁹⁵

(stock of one corporation for stock of another uncontrolled corporation) from the definition of like kind is inapplicable to the situation in Revenue Ruling 75-292. As manifested through legislative history, because of the continuity and identity of interest, stock received under a section 351 transfer is considered a continuation of the previous investment in merely a different form so that there is no taxable "cashing in" on the investment. See notes 88-89 *supra* & note 137 *infra*.

92. See, e.g., S. REP. NO. 398, 68th Cong., 1st Sess. (1924), reprinted in 1939-1 CUM. BULL. pt. 2, at 275. [hereinafter cited as S. REP. NO. 398].

93. Revenue Act of 1924, ch. 234, § 203(b)(1), 43 Stat. 256 (now INT. REV. CODE OF 1954, § 1031); Revenue Act of 1924, ch. 234, § 203(b)(4), 43 Stat. 256 (now INT. REV. CODE OF 1954, § 351). For a contemporary overview of the 1924 Act, see Magill, *Notes on the Revenue Act of 1924—Income Tax Provision*, 24 COLUM. L. REV. 836 (1924).

94. S. REP. NO. 398, *supra* note 92, at 278. H.R. REP. NO. 179, 68th Cong., 1st Sess. 12 (1924). As noted in the Senate report, the provision did not exempt, but merely postponed gain until realized by a "pure sale or by such an exchange as amounts to a sale." S. REP. NO. 398, *supra* note 92, at 278. In an exchange between Congressmen La Guardia and Green, it was established that selling property and immediately acquiring other property for the same business was not a tax-free exchange; because the property was reduced to cash, any gain would be taxed. 65 CONG. REC. 2799 (1924).

95. The preliminary report of the subcommittee of Committee on Ways and Means, printed in *Hearings on Revenue Revision Before the House Ways and Means Committee*, 73d Cong., 2d Sess. 58 (1934), recommended abolishing the exchange and reorganization provisions found in section 112 in order to prevent tax avoidance and simplify the law. The report reiterated that the principle embodied in the sections is that such transactions "result in mere paper profit, and that to tax them at the time of exchange [would] seriously interfere with business," *id.* at 58, but rejected this system of postponing tax on gain as unsound. *Id.* at 58. But see *id.* at 77, wherein Mr. Magill of the Treasury Department stated that the law should remain unchanged. Mr. Magill stressed the difficulty of computing the valuation of property in each case and stated that exempt exchanges were limited strictly to transactions in which it was administratively difficult to compute loss or gain. *Id.* at 56. These statements lend some support to the view expressed in *Century Elec. Co. v. Commissioner*, 192 F.2d 155, 159 (8th Cir. 1951), that in the enactment of section 112 Congress was concerned with the administrative problems of computing gain. Although this was a consideration, other statements during the hearing attest that the major concern was exemption from tax on "paper profits" so as to encourage necessary business readjustments. *Hearings on Revenue Revisions Before the House Ways and Means Committee*, *supra* at 290-91. See also *Jordan Marsh Co. v. Commissioner*, 269 F.2d 453, 456 (2d Cir. 1959), in which the court asserted that if the focus had been on the difficulty of making valuations, Congress would have provided for nonrecognition of loss and gain in *all* exchanges.

debates,⁹⁶ and committee reports⁹⁷ pertaining to the 1934 amendments,⁹⁸ which hold that purely formal "paper" transactions such as incorporations and like kind exchanges result in no immediate tax consequences.⁹⁹ Also, case law construing these two provisions consistently¹⁰⁰ has held that this theory is the principal justification for both sections.¹⁰¹ The cases emphasize that, though gain may have accrued in a constitutional sense, in such business and investment readjustments there has been only a nontaxable change in the form of ownership.¹⁰² The transactions are distinguished from sales because of the taxpayers' continued interest in

96. See, e.g., 78 CONG. REC. 2512 (1934) (letter from the Secretary of the Treasury). In his letter, the Secretary suggested amendments to the provisions rather than their elimination because elimination would have had a harmful effect on business whereas amendment would result in revenue savings and still allow nonrecognition to legitimate exchanges when the essential continuity of business and retention of interest exist. *Id.*

97. S. REP. NO. 558, 73d Cong., 2d Sess. (1934), reprinted in 1939-1 CUM. BULL. pt. 2, at 586, 598-99; H.R. REP. NO. 704, 73d Cong., 2d Sess. (1934), reprinted in 1939-1 CUM. BULL. pt. 2, at 554, 563-65. The Senate report emphasized that "some legitimate and desirable business readjustments would be prevented" by elimination of the provisions. S. REP. NO. 558, *supra* at 599.

98. Revenue Act of 1934, ch. 277, § 112(b)(1), 48 Stat. 704 (now INT. REV. CODE OF 1954, § 1031); Revenue Act of 1934, ch. 277, § 112(b)(5), 48 Stat. 704 (now INT. REV. CODE OF 1954, § 351).

99. In H.R. REP. NO. 704, 73d Cong., 2d Sess. 13 (1934) this code policy was stated as follows: A taxpayer whose "money is still tied up in the same kind of property as that in which it was originally invested . . . is not allowed to compute and deduct his theoretical loss on the exchange, nor is he charged with a tax on his theoretical profit."

100. For an exception to this, see note 95 *supra*.

101. See, e.g., *Carlton v. United States*, 385 F.2d 238, 241 (5th Cir. 1967) (construing section 1031); *Estate of Willett v. Commissioner*, 365 F.2d 760, 765 (5th Cir. 1966) (construing section 351); *Wolf v. Commissioner*, 357 F.2d 483, 485-86 (9th Cir. 1966) (construing section 351); *Jordan Marsh Co. v. Commissioner*, 269 F.2d 453, 457-58 (2d Cir. 1959) (construing section 112(b)(1) of the Internal Revenue Code of 1939, now section 1031 of the Internal Revenue Code of 1954); *Portland Oil Co. v. Commissioner*, 109 F.2d 479, 488 (1st Cir.), *cert. denied*, 310 U.S. 650 (1940) (construing section 112(b)(5) of the 1928 Act, now section 351 of the Internal Revenue Code of 1954); *Snead v. Jackson Sec. & Inv. Co. v. Commissioner*, 77 F.2d 19, 21 (5th Cir. 1935) (construing section 112(b)(5) of the 1928 Act); *American Compress & Warehouse Co. v. Bender*, 70 F.2d 655, 657 (5th Cir.), *cert. denied*, 293 U.S. 607 (1934) (construing section 112(b)(5) of the 1928 Act); *E. I. Du Pont de Nemours & Co. v. United States*, 471 F.2d 1211, 1214, 1217 (Ct. Cl. 1973) (construing section 351); *H. B. Zachary*, 49 T.C. 73, 80 (1967) (construing section 351); *Ethel Black*, 35 T.C. 90, 94 (1960) (construing section 1031).

102. See, e.g., *Jordan Marsh Co. v. Commissioner*, 269 F.2d 453, 455 (2d Cir. 1959) (construing section 112(b)(1) of the Internal Revenue Code of 1939, now section 1031 of the Internal Revenue Code of 1954); *Portland Oil Co. v. Commissioner*, 109 F.2d 479, 488 (1st Cir. 1940) (construing section 112(b)(5) of the Revenue Act of 1928, now section 351 of the Internal Revenue Code of 1954). See also *White, Sleepers that Travel with Section 351 Transfers*, 56 VA. L. REV. 37 (1970).

the property exchanged "by virtue of their control of the new corporate owner of it"¹⁰³ under section 351 and by virtue of their receipt of property of like kind under section 1031.¹⁰⁴

In Revenue Ruling 75-292, the rationale for the denial of section 1031 nonrecognition treatment was that the taxpayer received the property to exchange, not hold it,¹⁰⁵ thus deciding, in effect, that a taxpayer cannot engage in bona fide successive like kind exchanges and still receive favored treatment because he too will have acquired property to exchange, not hold it. As illustrated by the preceding examination of the legislative histories of the sections, such a result would thwart the statutory scheme of section 1031, which aims to afford nonrecognition to a taxpayer who has arranged a continuation of his investment in like kind property.¹⁰⁶ Moreover, application of the basic rule of statutory interpretation that "unless [the words of a statute] explicitly forbid it, the purpose of the statutory provision is the best test of the meaning of the words chosen,"¹⁰⁷ clearly validates construing the phrase "property to be held for productive use in trade or business"¹⁰⁸ to include property acquired to trade in a subsequent like kind exchange.

Thus, in holding that a section 1031 exchange, when followed by a section 351 transfer, did not qualify for favored treatment, the Service adopted the wrong mode of analysis. Both transactions would have qualified individually for nonrecognition¹⁰⁹ and both embody the same

103. *E. I. Du Pont de Nemours & Co. v. United States*, 471 F.2d 1211, 1215 (Ct. Cl. 1973), quoting *American Compress & Warehouse Co. v. Bender*, 70 F.2d 655, 657-58 (5th Cir.), cert. denied, 293 U.S. 607 (1934). The language of section 351 is broad and embraces some transactions that arguably should be sales, as when one transferor's economic position changes considerably and his continued control is extremely attenuated. To apply section 351 to such transfers is a "triumph of literalism." B. BITTKER & J. EUSTICE, *supra* note 82, at 3-4, 5. Yet to allow both sections 1031 and 351 favored treatment in a transaction combining the two is to enforce the legislative purpose by facilitating a legitimate business readjustment.

104. See Treas. Reg. 1.1002-1(b) (1960); Treas. Reg. 118, § 39.112(a)-1(b) (1939), reprinted in 3 J. MERTENS, *supra* note 19, § 20.16, at 74. The 1939 regulation elucidates the code policy of both sections 1031 and 351 providing: "[A]t 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 Internal Revenue Code provides that such differences shall not be deemed controlling . . ." Treas. Reg. 118, § 39.112(a)-(1) (b) (1939) *supra*.

105. Rev. Rul. 75-292, 1975 INT. REV. BULL. No. 29, at 19.

106. See notes 79-104 *supra* & accompanying text.

107. *Cawley v. United States*, 272 F.2d 443, 445 (2d Cir. 1959).

108. INT. REV. CODE OF 1954, § 1031(a).

109. Both sections are exceptions to the general rule of recognition of gain. See Treas. Reg. 1.1002-1(b) (1960).

legislative philosophy.¹¹⁰ A section 1031 exchange, standing alone, would receive tax-free treatment; why should that exchange be taxed merely because it is used in combination with a section 351 transaction?¹¹¹

It is axiomatic that tax consequences are determined by what was actually and ultimately done;¹¹² that is, the transaction must be viewed in its entirety to determine its true substance.¹¹³ In conformity with this requirement, by applying the step transaction doctrine,¹¹⁴ collapsing the tandem sections 1031-351 transfers and disregarding the intermediate step, the end result is that the taxpayer has received stock in exchange for like kind property. This result, impermissible under the existing statute, appears to be the real reason for the Service's denial of section 1031 treatment. The enigma lies in the failure by the Service to apply the widely used step transaction doctrine in this situation.

THE UNQUALIFIED APPLICATION OF THE STEP TRANSACTION
DOCTRINE EFFECTS RESULTS UNDESIRABLE
TO THE INTERNAL REVENUE SERVICE

Under the step transaction doctrine, a tool used in the search for substance over form,¹¹⁵ in determining tax consequences the separate steps in a transaction are consolidated, and the transaction is viewed as a whole. The doctrine may not be applied indiscriminately, however.¹¹⁶

110. See notes 79-104 *supra* & accompanying text.

111. An application of the Service's reasoning to the reverse situation, in which the individual taxpayer first incorporates under section 351 and then has his controlled corporation engage in a section 1031 exchange in order to acquire a larger holding, would deny to the corporation nonrecognition treatment because it acquired the property not to hold, but to exchange. *But see* Estate of Rollin E. Meyer, Sr., 58 T.C. 311, 316 n.2 (1972) (Dawson, J., dissenting in part).

112. *Weiss v. Stearn*, 265 U.S. 242, 254 (1924).

113. See, e.g., *Kanahwa Gas & Util. Co. v. Commissioner*, 214 F.2d 685, 691 (5th Cir. 1954); *Century Elec. Co. v. Commissioner*, 192 F.2d 155, 159 (8th Cir. 1951).

114. See notes 115-32 *infra* & accompanying text.

115. See *Weiss v. Stearn*, 265 U.S. 242, 254 (1924); *Crenshaw v. United States*, 450 F.2d 472, 478 (5th Cir. 1971); *Casner v. Commissioner*, 450 F.2d 379, 398 (5th Cir. 1971). See generally Mintz & Plumb, *Step Transaction in Corporate Reorganizations*, N.Y.U. 12th ANNUAL INST. ON FED. TAX. 247 (1954).

116. See 3 J. MERTENS, *supra* note 19, §§ 20.47, at 167, 20.161, at 731. In order to determine when to apply the doctrine, two approaches have been used. The first involves the application of the "interdependence" test, in which the court ascertains whether the steps are so interrelated that one would not have been taken without the other and a separation of them would destroy the intent of each. See *American Wire Fabrics Corp.*, 16 T.C. 607, 615 (1951); *American Bantam Car. Co.*, 11 T.C. 397, 405 (1948), *aff'd*

Just as an integrated transaction may not be divided arbitrarily into independent steps,¹¹⁷ independent steps may not be consolidated arbitrarily to form a whole;¹¹⁸ only interdependent steps may be collapsed into one.¹¹⁹

Such interdependence clearly exists in the situation described in Revenue Ruling 75-292, because the sections 1031 and 351 exchanges occurred pursuant to a prearranged plan.¹²⁰ It is irrelevant that each exchange taken separately is a nontaxable event.¹²¹ Rather, in establishing the tax consequences of these transfers, the step transaction doctrine should be applied and both exchanges treated as a single indivisible transaction.¹²² By thus using sections 1031 and 351 together, nonrecognition status is lost at the section 1031 stage even though individually each transfer would be favored, for under the step transaction doctrine, the

per curiam, 117 F.2d 513 (3d Cir. 1949), *cert. denied*, 337 U.S. 920 (1950). See also Mintz & Plumb, *supra* note 115, at 250-52. The second approach involves the application of the "end result" test, in which a transaction is viewed as a whole if the ultimate result was intended from the outset. See 3 J. MERTENS, *supra* note 19, § 20.166, at 774-75; Mintz & Plumb, *supra* note 115, at 250.

117. See *Tennessee, Ala. & Ga. Ry. Co. v. Commissioner*, 187 F.2d 826, 830 (6th Cir. 1951); *Commissioner v. Ashland Oil & Ref. Co.*, 99 F.2d 588, 591 (6th Cir. 1938).

118. See Mintz & Plumb *supra* note 115, at 248.

119. Relevant factors that should be considered in ascertaining whether a transaction is an integrated whole are the intent of the parties, the time element, the ultimate result and mutual interdependence of the steps. 3 J. MERTENS, *supra* note 19, § 20.47, at 167-68. See also *American Wire Fabrics Corp.*, 16 T.C. 607 (1951), *quoting* *American Bantam Car. Co.*, 11 T.C. 397, 405 (1948), *aff'd per curiam*, 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S. 920 (1950). In *American Wire* the court found that a series of steps should be treated as a single indivisible transaction only if the steps are "so interdependent that the legal relations created by one transaction would have been fruitless without the completion of the series." 16 T.C. at 613.

Notably, steps may be interdependent even though substantial time has elapsed, because the test is functional, not temporal. *Stanley, Inc. v. Schuster*, 295 F. Supp. 812, 817-18 (S.D. Ohio 1969), *aff'd per curiam*, 421 F.2d 1360 (6th Cir. 1970) (two steps separated by four years held to constitute a single transfer). See also 3 J. MERTENS, *supra* note 19, § 20.161, at 737-38; Mintz & Plumb, *supra* note 115, at 248.

120. See Rev. Rul. 70-140, 1970-1 CUM. BULL. 73 (two steps of a transaction carried out according to a prearranged, integrated plan cannot be considered separately for tax purposes); 3 J. MERTENS, *supra* note 19, § 20.161, at 738. See also *May Broadcasting Co. v. United States*, 200 F.2d 852, 857 (8th Cir. 1953).

121. *Crenshaw v. United States*, 450 F.2d 472, 475-76, 478 (5th Cir. 1971); *Pickard v. Commissioner*, 113 F.2d 488 (2d Cir.), *aff'g per curiam*, 40 B.T.A. 258 (1940).

122. See, e.g., *Waterman Steamship Corp. v. Commissioner*, 430 F.2d 1185, 1192 (5th Cir. 1970); *Kanahwa Gas & Util. Co. v. Commissioner*, 214 F.2d 685, 691 (5th Cir. 1954). In *Kanahwa Gas & Utilities Co.*, the court stated that preconceived unitary plans will be regarded as an entirety "whether the effect of so doing is the imposition of or relief from taxation." *Id.*

result of the two transactions is the receipt of stock for like kind property. Although acceptable under section 351, this result affronts section 1031.¹²³

Why then, in denying section 1031 treatment to this integrated transaction, did the Service fail to apply such a well established and apparently appropriate doctrine? Certainly an application of the step transaction doctrine to situations with successive section 1031 exchanges is mandated by legislative history¹²⁴ and by the Service's acceptance of the closely analogous simultaneous three-way exchange.¹²⁵ In a three-way exchange, the taxpayer holds acceptable like kind property throughout the exchange transaction and clearly qualifies for nonrecognition.¹²⁶ On the other hand, a three-party, two-step exchange may be structured in such a manner as to entail the use of impermissible property in the exchange and thus affront the express wording of section 1031, while at the same time qualifying as a valid section 1031 exchange under the step transaction doctrine. For instance, if a taxpayer arranges to exchange his business real estate for stock of an uncontrolled corporation, and then, pursuant to a prearranged plan, exchanges the acquired stock for a third party's business real estate,¹²⁷ under the step transaction doctrine, by viewing the exchange in its entirety and disregarding the intermediate step,¹²⁸ the taxpayer would qualify for section 1031 treatment.¹²⁹ Such an application of the doctrine, however, ignores the fact that the intermediate step in the exchange involved the receipt of impermissible section 1031 property,¹³⁰ and thereby suggests that the use of such prop-

123. See note 1 *supra*.

124. See notes 79-104 *supra* & accompanying text.

125. See notes 69-78 *supra* & accompanying text.

126. See notes 74-76 *supra* & accompanying text.

127. If A owns business real estate PA; B owns stock of corporation X and C owns business real estate PC, the transaction is as follows:

A exchanges PA with B for stock of corporation X.

A exchanges the stock of corporation X with C for PC.

128. Upon disregarding the intermediate step, see note 77 *supra*, A has exchanged, in effect, PA for PC, a transfer of business real estate, clearly a like kind transaction under section 1031. See note 40 *supra* & accompanying text.

129. That the intermediate step involved a transaction taxable under section 1031 (that is, the exchange of business real property for stock), see INT. REV. CODE OF 1954, § 1031 (a), does not make this transaction considered in its entirety taxable under the step transaction doctrine because "the individual tax significance of each step is irrelevant when, considered as a whole, they all amount to no more than a single transaction" *Crenshaw v. United States*, 450 F.2d 472, 476 (5th Cir. 1971).

130. See note 1 *supra*.

erty in the disregarded intermediate step is acceptable, a result that offends the express wording of section 1031.¹³¹ Moreover, the use of the step transaction doctrine in this type of exchange contravenes the underlying assumption of section 1031 that the new property is substantially a continuation of the prior investment still unliquidated. The taxpayer's continuity of interest in his business real estate was terminated by the receipt of the stock as full consideration for his property, and the proceeds then merely were reinvested in like kind property.¹³² The Service, therefore, may have failed to apply the step transaction doctrine in Revenue Ruling 75-292 because of a fear of potential resulting violations of the express wording and underlying basis of section 1031.

A SUGGESTED REVISION OF THE STATUTE TO ALLOW
FOR THE COMBINED USE OF SECTIONS 1031 AND 351

Examination of the step transaction doctrine has revealed that a blanket application of the doctrine to three-party, two-step exchanges may contravene both the explicit language of section 1031, by allowing the exchange of impermissible property, and the section's underlying policy of continuity of investment.¹³³ Nevertheless, because such property was received via a section 351 transfer and in pursuit of the type of legitimate business needs Congress sought to facilitate, the facts of Revenue Ruling 75-292 can be distinguished clearly from other three-party, two-step transactions, in which impermissible property intervenes via another route. In the latter situation, the taxpayer's receipt of the

131. "No gain or loss shall be recognized if property held for production use in trade or business or for investment (not including . . . stocks . . .) is exchanged . . ." INT. REV. CODE OF 1954, § 1031(a).

132. In opposition to the Service's apparent stance it has been proposed that the most logical and fair approach to determining the substance of section 1031 exchanges is to view the net result of the completed transaction, focusing simply on whether like kind property was transferred and ultimately received. See Leslie Q. Coupe, 52 T.C. 394, 415 (1969) (Simpson, J., concurring). See also *Section 1031*, *supra* note 22, at 524-25; *Tax Free*, *supra* note 18, at 474; 24 ARK. L. REV. 142, 147 (1971). Such an approach would implicitly allow the use of impermissible property during the intervening step. This approach has been rejected by the courts. For example, in *Carlton v. United States*, 385 F.2d 238, 241 (5th Cir. 1967), the court stated that to ascertain the reality of a transaction it could not "merely look at the beginning and end . . . without observing the steps taken to reach that end," and in *John M. Rogers*, 44 T.C. 126, 136 (1965), the court rejected the taxpayer's argument that "the difference in how the end result is accomplished is immaterial."

133. See note 127-32 *supra* & accompanying text.

impermissible property¹³⁴ from a third party as consideration for his property results in a "cashing in" of his investment in that property.¹³⁵ His subsequent reexchange is merely a reinvestment of the proceeds from the sale of the original property. In marked contrast, the impermissible property received by a taxpayer in an exchange with a corporation he controls is considered, as established by legislative history,¹³⁶ a continuation of the taxpayer's prior investment, effectuating merely a non-taxable change in the form of ownership.¹³⁷ The exchange in Revenue Ruling 75-292 thus retains the necessary continuity of investment even though the receipt of stock contravenes the language of section 1031. Therefore, had the Service administratively legislated and held permissible a transaction involving a section 1031 exchange coupled with a subsequent section 351 transfer, it would have eroded the explicit Congressional limitation that property cannot be exchanged for stock.

Because, in the facts of the revenue ruling, the requisite continuity of interest and control are present, cannot the second step (the section 351 transfer) be viewed as a continuation of a like kind investment in merely a different form? That sections 1031 and 351 share common goals, both aiming to facilitate necessary business readjustments and avoid taxation of mere changes in form of investment, is manifest through the examination of their legislative histories¹³⁸ and of case law construing the sections.¹³⁹ Because of this close interrelation and the bona fide business needs sought, incorporation of a sole proprietorship accompanied by a transfer of newly acquired expanded facilities, the two sections should be allowed to coexist in tandem without destroying the tax-free status of either.

The defect thus appears to lie not in the Internal Revenue Service's disallowance of section 1031 treatment under the existing statute, but

134. For an example of this type of three-party, two-step exchange, see notes 127-32 *supra* & accompanying text.

135. See note 1 *supra*.

136. See notes 79-104 *supra* & accompanying text.

137. This contention is supported by the assertion in *W & K Holding Corp.*, 38 B.T.A. 803 (1938), that a change from individual to corporate ownership works no substantial change in the beneficial ownership and control of the property. *Id.* at 839. In *George A. Nye*, 50 T.C. 203 (1968), stock transferred under section 351 was deemed evidence of a *continuing* investment in the property given as a permanent contribution to the corporation. *Id.* at 213. Similarly, in *Lubrot v. Burnet*, 57 F.2d 413 (D.C. Cir. 1932), the court stated that certificates of stock in a controlled corporation "were for all practical purposes . . . muniments of title to the same property." *Id.* at 414.

138. See notes 79-104 *supra* & accompanying text.

139. See notes 100-104 *supra* & accompanying text.

rather in Congress' failure to recognize statutorily the interplay between the two sections so as to allow the combined use of the provisions to fulfill valid business and investment needs and thus further their common goals. Congress should uphold the policy espoused for each section individually by expressly allowing the combined use of the two. It is proposed, therefore, that section 1031 be revised to allow the receipt of stock as an end result but only when the section 1031 exchange is coupled with a section 351 transfer.¹⁴⁰

140. It is immaterial whether the section 351 transfer precedes or follows the section 1031 exchange.