A PROPOSAL FOR SIMPLIFICATION OF TAX-DEFERRED EXCHANGES

By eliminating the need for a nonsimultaneous or other type of exchange in order to defer taxes, the current U.S. tax law can be simplified, and taxpayers can concentrate on the economics of an investment decision.

by Mark Lee Levine

This article was based on a paper the author previously had prepared in 1988.

Tax-deferred exchanges under Internal Revenue Code Section 1031 have been in the federal income tax law for many years; the basic precepts that formed its foundation were built on legislation passed prior to 1924.[1] Although Code section 1031[2] has been with us for many years, many questions continue regarding its interpretation and application. Interpretive questions under this code include whether real property qualifies as a tax-deferred exchange: Does real property meet the requirements of "like-kind" property? Does it meet requirements of an exchange, etc.?

Code section 1031, as it currently exists, eliminates the recognition of *gain or loss* from an exchange of property. The section applies only to the exchange of property (not services). To be covered by section 1031, property must be held (not acquired for resale), and it must be held for productive use in trade or business or for investment. Property that does not fit these categories, such as property acquired for resale (dealer property), is not covered by the section. However, if property is not exchanged solely for like-kind property, partial recognition of gain or loss is possible.

Problems in the interpretation of exchanges have generated substantial litigation since the inception of section 1031. The U.S. Congress has added to the broth, stirring the waters and fomenting additional litigation by making changes in the section, particularly by making the 1984 change. This allows section 1031, to be applied even to exchanges that are not simultaneous.

The focus of this article is to examine the implications that a nonsimultaneous exchange has on litigation and controversy. Stemming from a desire to simplify tax law, the article proposes modifying code section 1031 to eliminate the need for nonsimultaneous exchanges or, for that matter, any exchanges to allow deferral of tax.

Although many areas of litigation have arisen under this code, the direction of the article is on the nonsimultaneous exchange, which has been labeled by proposed regulations as a deferred exchange. The *T.J. Starker v. U.S.*[3] case and other court cases[4] have questioned whether an exchange could be nonsimultaneous and still fall within the code.

Congress saw fit to address this issue and apparently "put it at rest" by allowing nonsimultaneous exchanges within the limited language of the statutory change under the Deficit Reduction Act of 1984.[5] That change provided the now-famous 45/180 day rule, which holds that property will not qualify for code section 1031 if it "is not identified as property to be received in the exchange on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquishing the exchange...."[6] In other words, when a taxpayer

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transfers his property, he must receive property in exchange within 45 days of the transfer.[7]

In addition to the 45-day transfer requirement, the Deficit Reduction Act also provided that property will not be considered of like-kind if it "... is received after the earlier of: (i) the day which is 180 days after the date on which the taxpayer transfers the property relinquishing the exchange, or (ii) the due date (determined with regard to extension) for the transferor's return of the tax imposed . . . . (by the Tax Law)."[7] Thus, if an exchange is not simultaneous, the property to be received by the taxpayer must be identified within 45 days of the transfer. In fact, the taxpayer must actually receive that property within 180 days of the date on which the taxpayer transferred his property. Or the taxpayer must receive the property within 180 days of the date, including extensions, on which the taxpayer's tax return is due under the tax law that applies to the year in which the transfer of property occurred.

One might argue that the language used by Congress was intended to "eliminate" ambiguities and uncertainties concerning nonsimultaneous exchanges. It is the thesis of this article that Congress' language has fueled fires of concern regarding nonsimultaneous exchanges and has added a new dimension in "creativity" related to nonsimultaneous exchanges. It is also a contention of this article that perhaps Congress should focus its attention on whether a nonsimultaneous exchange or any other type of exchange should be required to allow deferral of taxes.

The Theory Behind Code Section 1031

The purpose of code section 1031 has not been made clear, notwithstanding the many court cases that have referred to the theory behind the section.

In *T.J. Starker v. U.S.*, the most famous case involving non-simultaneous exchanges, the Ninth Circuit Court examined some of the reasons for an exchange.[8] Circuit Court Judge Goodwin acknowledged that in the Starker case, the government and the taxpayer presented arguments concerning the existence of a nonsimultaneous exchange based on the history and purpose of code section 1031. In response, Judge Goodwin stated: "A proper decision can be reached only by considering the purposes of the statute and analyzing its application to particular facts under existing precedent. Hereunder, the statute's purposes are somewhat cloudy, and the precedents are not easy to reconcile."[8]

Judge Goodwin mentioned that history reveals the provision was ". . . designed to avoid the imposition of a tax on those who do not 'cash in' on their investments in trade or business property." Judge Goodwin considered whether the reason for code section 1031 was to protect taxpayers who did not have the money to pay the tax.

However, he found that liquidity was not the sole reason for the section. As Judge Goodwin stated, if a taxpayer sold property for cash and reinvested the money, the taxpayer would not have money to pay taxes, but the taxpayer nevertheless could not use code section 1031 to defer taxes.

Judge Goodwin also considered the argument that it would be difficult to measure gain or loss on an exchange. However, he countered this position by citing the fact that if a taxpayer received even $1 of boot, that money would not constitute like-kind property, and a valution would be necessary. He therefore concluded that measurement of gain or loss could not be the sole reason for section 1031.

Judge Goodwin cited other concerns with section 1031 and concluded that the intent of the drafters of the legislation was not clear; the section could exist for many reasons.

It should be remembered that code section 1031 existed for many years without focusing on the nonsimultaneous exchange. Once the *Starker* case became well known to those in exchange circles, the potential for use (and possibly for abuse) of section 1031 with the nonsimultaneous exchange became well known. Congress reacted by choosing between two positions: making it clear that a nonsimultaneous exchange would not qualify under code section 1031 or limiting the time frames in the section to cover a nonsimultaneous exchange. Congress chose the latter route.

Form Over Substance, Tax Traps, More Litigation And a Question Of Identification

After the 1984 change in tax law that reaffirmed the posture of a nonsimultaneous exchange, numerous additional questions have arisen. Those questions include, but are not limited to, such issues as determining:

when the closing or transfer takes place

when the property is properly identified

when a trust or other security is acceptable, and when it taints the exchange

whether a constructive receipt exists

how much control is allowed to a taxpayer without violating the code section 1031 requirements

Additional questions have arisen as to proper format of transactions and direct deeding. That is, if taxpayer T transfers his property to taxpayer X and then subsequently identifies a property to be received from taxpayer Y in exchange, can taxpayer Y transfer the property to taxpayer T, or must he transfer the property to another party who, in turn, transfers it to taxpayer T? These items are beyond the scope of this examination.[9]

We have seen numerous companies who represent that they handle "*Starker* trusts." Such activity is questionable, given the fact that the *Starker* case did not involve a trust; consequently, there is no absolute case authority for a "*Starker* trust" position. The lack of case authority does not mean that the companies that handle a "*Starker* trust" are incorrect. It simply means that we have more activity in attempting to develop form over substance, more formality and, more costs in structuring exchanges and numerous concerns resulting from construing the statutory changes on the 45/180 day rules. Although some of these issues have been considered by the 1990 proposed regulations for code section

1031; these issues also elicit concern about the level and breadth of complexity in current tax law.

Suggested Statutory Change

It seems that a reasonable approach for Congress in the "exchange" area would be to follow the concept of code section 1034.[10] Code section 1034 provides, as many practitioners know, a basic rule for allowing the *sale* (not limited to an exchange) of a principal residence, the taking of the monies and the reinvestment of those funds in a timely fashion to postpone a recognition of gain.

Code section 1034 is very broad; it allows for a two-year time frame in which an old residence may be sold and a new residence purchased without incurring taxes on the gain that may be generated as a result of that sale. Admittedly, there are numerous requirements under code section 1034. However, this section allows the taxpayer to rollover the gain on the sale of his principal residence into another residence within two years.

Why is it that Congress has not allowed a similar approach under code section 1031? Why has Congress placed the taxpayer in a position where mental gymnastics, form and stretched construction are necessary to formulate the transaction so he does not receive cash but has enough control or protection to secure his position until like-kind property is acquired? Why hasn't Congress simply allowed the taxpayer to undertake an exchange, receive cash and invest that money in a given time frame?

The quick historical retort to this approach is that Congress has never allowed this position and does not intend to allow it. An exchange is one thing! A sale is another! Certainly, the court cases make this point. However, as Judge Goodwin so aptly stated in the *Starker* case, there often is little difference in result if a taxpayer undertakes a simultaneous exchange or if he sells his property, takes the money and reinvests it one day later. The economic position is the same, although the tax position is substantially different: the exchange falls within code section 1031 but the cash sale does not.

Taxpayers who use the 45/180-day rule may be simply selling their property, placing the cash in trust and seeking another property. Isn't this situation similar in intent to the situation covered by code section 1034 except that it is dressed with formality and structures, such as a trust, to force the circular peg into the square hole?

Admittedly, there are substantial differences between code section 1031 and code section 1034. However, I am not advocating throwing out the baby with the bathwater. Rather, I am stating that if this code section covers property used in trade or business or held for investment, it would be less burdensome, more straightforward and more advantageous in an administrative fashion to allow taxpayers to simply sell their property and reinvest the proceeds than to develop trusts or similar vehicles in an attempt to meet the requirements of code section 1031. The proposed 1990 regulations allow more flexibility for nonsimultaneous exchanges. Why not go this next step?

Recent comments by some authors have suggested the same idea, but they have suggested a reinvestment time of 180 days. Why not simply allow the sale and the reinvestment, even with the reduced time frame? Congress does not have to have a two-year rule, similar to code section 1034, when applying code section 1031. However, if Congress allowed the sale of property and the reinvestment of the proceeds within a given time frame, the need for a trust, the concern about whether deeding is direct or not direct, the concern about the format of exchange documents, and so forth, would be eliminated or at least substantially reduced in many settings.

Taxpayers could then concentrate on the economic decisions that need to be made about whether to make an investment or a reinvestment. To constrict taxpayers by the language of code section 1031, to force the creation of some means of allowing for security whether it be a trust or a security in the form of real estate or otherwise, appears to do nothing but complicate the tax law, an objective that, at least by official pronouncement of the present legislature and administration, is not desired. If we want to simplify the tax law, as Congress so often labels its tax laws,[11] this may be one step in the right direction.

Conclusion

Congress, along with the Bush Administration, have prided themselves on undertaking the simplification of the tax law to work with, not against, the taxpayer. If this is a legitimate goal, then it certainly is appealing to modify code section 1031 to allow for sale of property and reinvestment of the sale's proceeds within a given time frame and within the concepts and structure of the section.

This position will not be a panacea; however, it will go a long way toward eliminating much of the activity that has been generated by undertaking a nonsimultaneous exchange and thus forcing the transaction to allow for security and meet the 45-day and 180-day time frames rule.

Although modified, possibly by time frame and property-type restrictions, there is no reason Congress cannot modify code section 1031 to allow the same type of treatment that exists under code section 1034, thereby eliminating numerous complications in an already overburdened Internal Revenue Code and tax maze.

NOTES

1. See Levine, Mark Lee. *Real Estate Exchanges* p 2. (Realtors National Marketing Institute/Professional Publications and Education, Inc., 1981, as amended): See also Levine, Mark Lee. *Exchanging Real Estate*, vol. 1, (PP&E, 1990) Chapter 1. The Bureau of National Affairs, *Portfolio #61-3rd*, covers the historical background of Code §1031.
2. See 26 USCA (IRC 1986) Code §1031, herein referred to as the Code.
3. See *T.J. Starker v. U.S.*, 77-2 USTC ¶9512, 432 F. Supp. 864 (D.C., Ore. 1977), affirmed and remanded under 79-2 USTC ¶9541, 602 F.2d 1341 (9th Cir. 1979). See Code §1031 (a) (3) that was modified to allow nonsimultaneous exchanges. See also note 4, *infra* herein, as to proposed regulations in this area. For an in-depth discussion of this issue, see Levine, Mark Lee. *Real Estate Exchanges, Supra* note 1; p. 211. See also Levine, Mark Lee. "Tax-Deferred Exchanges after TRA of

1986," *Journal of Property Management* (November, 1987). See also Levine, Mark Lee. "Exchanging Your Property for Your Property," NACORE, *Corporate Real Estate* (1989). See also Levine, Mark Lee. " '*Starker* Trusts' " and Cheshire Cats: You Can't See Either for Sure," RNMI *Commercial Investment Real Estate Journal* (Spring, 1989).

4. For cases that have discussed nonsimultaneous exchanges, see discussion of these cases in Levine, Mark Lee. *Real Estate Exchanges* cited *supra* note 1. See also *Red Wing Carriers, Inc. v. Tomlinson*, 68-2 USTC ¶9540, 399 F.2d 652 (5th Cir, 1968). See also private letter rulings that have addressed the question of nonsimultaneous exchanges, namely Private Letter Rulings 7938087, 8005049 and 8046122. These are discussed in the Levine text *supra* note 1. See also Levine, Mark Lee. *Real Estate Transactions* (West Publishing Co: St. Paul, Minn, 1990): chapter 29, Section 577. See 26 C.F.R. Part 1, IA-237-84, RIN 1545-AH43 (5/16/90) for the 1990 proposed regulations in the area of nonsimultaneous exchanges.
5. See Public Law 98-369, 7/18/84.
6. See Code §1031(a)(3).
7. Code §1031(a)(3) was modified under a 1986 change to make it clear that the transfer must occur within 45 days and 180 days. See Public Law 99-514 (10/22/86).
8. For a discussion of the *Starker* cases, see the citation *supra* note 3. For a review of some of the reasons to allow exchanges, see *Biggs, Franklin* 632 F.2d 1171 (5th Cir, 1980). See also a review of these issues in Levine, Mark Lee. *Exchanging Real Estate (1990) and Real Estate Exchanges* cited *supra* note 1. For background in this area, see Private Letter Rulings 7938087, 8005049 and 8046122.
9. For a detailed discussion of these issues, see the authority cited earlier, especially the Levine texts. In particular, see the cases of *Barker v. Comm.*, 74 TC 555 (1980). See also *Biggs v. Comm.*, 81-1 USTC ¶9114 (5th Cir, 1981).
10. See 26 USCA §1034. For a detailed discussion of this area, see also the Levine text, *Real Estate Transactions, Tax Planning*, Chapter 28, cited *supra* note 4.
11. One need simply look at the history of recent tax legislation to see all of the "simplification" acts.