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## COMMENTS

# THE EXCHANGE REQUIREMENT IN MULTIPARTY AND NONSIMULTANEOUS EXCHANGES: A CRITICAL ANALYSIS AND STATUTORY SOLUTION

by Robert H. Voelker

**S**ECTION 1031(a) of the Internal Revenue Code<sup>1</sup> provides for nonrecognition of gain or loss on exchanges of like-kind property.<sup>2</sup> This section contains a multitude of traps for the unwary tax practitioner. Because the narrow language of the statute is not easily applied to the complexity of many modern transactions, the Internal Revenue Service and the courts have reclassified some well-intentioned exchanges as sales and repurchases, thereby defeating attempted nonrecognition under section 1031. This Comment analyzes the provisions and potential pitfalls of section 1031 in light of judicial decisions that have construed the statute liberally. Such an analysis suggests that the courts have emasculated the congressional intent underlying the nonrecognition provision. This Comment therefore concludes that section 1031 should be amended to meet the realities of modern transactions and to provide a greater degree of certainty for the tax practitioner structuring like-kind exchanges.

### I. CONGRESSIONAL INTENT

Congress promulgated section 1031(a), as well as its predecessor,<sup>3</sup> to provide deferral of taxation on simple barter transactions.<sup>4</sup> The legislative

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1. I.R.C. § 1031(a) (1976).

2. Section 1031(a) provides: "No gain or loss shall be recognized if property held for productive use in trade or business or for investment . . . is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment." *Id.* The words "like kind" refer to the nature or character of property rather than to its grade or quality. Treas. Reg. § 1.1031(a)-1(b) (1967). The requirement of an exchange for property of like kind basically prohibits exchanges of real property for personal property and vice versa. I S. GUERIN, TAXATION OF REAL ESTATE DISPOSITIONS § 11.01 (1982); *see also* I. FAGGEN, D. BLOCKOWICS, J. SCHWIETERS, D. BRADFORD, J. BROWN, M. SCHWARZ, R. STEVENS & D. WATERS, FEDERAL TAXES AFFECTING REAL ESTATE § 8.01[3] (Rev. 5th ed. 1983) (general discussion of like-kind requirement).

3. Internal Revenue Code of 1939, § 112(b) (current version at I.R.C. § 1031(a) (1976)).

4. *See United States v. Vardine*, 305 F.2d 60, 65-66 (2d Cir. 1962); *Trenton Cotton Oil*

history to the nonrecognition provision indicates that one of Congress's purposes in allowing tax-free exchanges was to eliminate the administrative expense of valuing every "horse trade" transaction that occurred.<sup>5</sup> Another apparent motive was protection of the revenues against wash sales transactions, in which the taxpayer's economic status remains the same but the taxpayer nevertheless claims a tax loss resulting from a sale of investment property and immediate repurchase of an identical investment.<sup>6</sup> Some courts have recognized that these factors motivated Congress in passing section 1031(a),<sup>7</sup> but most decisions have expressly rejected them as controlling.<sup>8</sup>

The primary legislative purpose for the nonrecognition statute is not clear,<sup>9</sup> and courts have attributed several different rationales to Congress. Many courts have stated that the basic reason for the special treatment of like-kind exchanges is that the taxpayer's economic situation after the exchange is fundamentally the same as it was before the exchange.<sup>10</sup> This rationale for nonrecognition is known as the "continuity of interest" or "continuity of investment" doctrine.<sup>11</sup> The continuity of interest theory holds that a taxpayer should not be taxed on an exchange in which he has not cashed in on his investment. Although the taxpayer may realize a gain

Co. v. Commissioner, 147 F.2d 33, 36 (6th Cir. 1945); H.R. REP. NO. 704, 73d Cong., 2d Sess. (1934), *reprinted in* 1939-1 C.B. (Pt. 2) 554, 564; H.R. REP. NO. 304, 67th Cong., 1st Sess. (1921), *reprinted in* 1939-1 C.B. (Pt. 2) 168, 175.

5. *Starker v. United States*, 602 F.2d 1341, 1352 (9th Cir. 1979); *Godine v. Commissioner*, 36 T.C.M. (CCH) 1595, 1597 (1977); H.R. REP. NO. 704, 73d Cong., 2d Sess. (1934), *reprinted in* 1939-1 C.B. (Pt. 2) 554, 564; Van Dorn, *Planning Tax-Free Like-Kind Exchanges of Real Estate*, in *TAXATION OF REAL ESTATE TRANSFERS AND SALES* 35, 42-43 (J. Halpern ed. 1979); Duhl, *Like-Kind Exchanges Under Section 1031: Multiparty Exchanges, Non-simultaneous Exchanges and Exchanges of Partnership Interests*, 58 *TAXES* 949, 950 (1980); Levine, *Simultaneity in Exchanges: Does Code Sec. 1031 Require Simultaneity of Exchange?*—*Starker II on Appeal*, 58 *TAXES* 145, 149 (1980).

6. H.R. REP. NO. 350, 67th Cong., 1st Sess. (1921), *reprinted in* 1939-1 C.B. (Pt. 2) 168, 176.

7. *Starker v. United States*, 602 F.2d 1341, 1352 (9th Cir. 1979) (valuation); *Century Elec. Co. v. Commissioner*, 192 F.2d 155, 159 (8th Cir. 1951) (wash sales); *Godine v. Commissioner*, 36 T.C.M. (CCH) 1595, 1597 (1977) (valuation); *Smith v. Commissioner*, 34 T.C.M. (CCH) 704, 705 (1975) (wash sales).

8. *Jordan Marsh Co. v. Commissioner*, 269 F.2d 453, 456 (2d Cir. 1959); *Coupe v. Commissioner*, 52 T.C. 394, 408 (1969). The continuity of investment rationale is the dominant motive that recent decisions have attributed to Congress. *See infra* notes 10-11 and accompanying text.

9. *Starker v. United States*, 602 F.2d 1341, 1352 (9th Cir. 1979) (legislative purpose is "elusive").

10. *E.g.*, *Redwing Carriers, Inc. v. Tomlinson*, 399 F.2d 652, 656 (5th Cir. 1968); *Carlton v. United States*, 385 F.2d 238, 241 (5th Cir. 1967); *Jordan Marsh Co. v. Commissioner*, 269 F.2d 453, 457 (2d Cir. 1959); *Century Elec. Co. v. Commissioner*, 192 F.2d 155, 159 (8th Cir. 1951); *Godine v. Commissioner*, 36 T.C.M. (CCH) 1595, 1597 (1977); *Smith v. Commissioner*, 34 T.C.M. (CCH) 704, 705 (1975), *aff'd*, 537 F.2d 972, 975 (8th Cir. 1976).

11. *See Wagensen v. Commissioner*, 74 T.C. 653, 658 (1980); *Koch v. Commissioner*, 71 T.C. 54, 63-64 (1978). The notion of continuity of investment pervades other nonrecognition provisions of the Code. *See, e.g.*, I.R.C. § 351 (1976 & Supp. V 1981) (nonrecognition of gain or loss on transfer of property to controlled corporation); *id.* § 354 (1976 & Supp. V 1981) (nonrecognition of gain or loss on exchanges of stock in certain reorganizations); *id.* § 355 (1976 & Supp. V 1981) (nonrecognition of gain or loss to shareholders on stock dividends).

or loss on the transfer, his overall economic status continues unchanged; thus, like the requirement of a discernible realizing event prior to taxation,<sup>12</sup> the continuity of interest theory disallows tax on a mere exchange. This line of reasoning appears to explain in part Congress's rationale for section 1031(a); it is not, however, entirely persuasive. A taxpayer's economic position is similarly unaltered by a sale of property and reinvestment of the proceeds,<sup>13</sup> but such a transaction is expressly taxable.<sup>14</sup> Congress therefore must have perceived factors in addition to continuity of interest that set like-kind exchanges apart from other transactions.

Some courts have noted that the imposition of a tax on persons who roll over investments into like-kind property would result in a liquidity problem for taxpayers who lack sufficient cash to pay the tax.<sup>15</sup> Although this factor is not mentioned in the legislative history to section 1031, the courts reason that Congress, in its deliberations on the nonrecognition statutes, must have been concerned about taxing illiquid taxpayers.<sup>16</sup> This rationale is limited, however, because a taxpayer who enters into a sale and repurchase transaction also does not experience any increase in liquidity, but nevertheless is expressly subject to tax.<sup>17</sup> Cash flow considerations cannot, therefore, be the sole motive behind the special tax treatment afforded to exchanges.

Courts have also attributed valuation considerations to Congress as the rationale underlying section 1031.<sup>18</sup> Exchanges typically do not involve valuation of the properties exchanged even though in reality both parties assess the relative worth of the properties in determining the benefits of entering into the exchange. The absence of an objective means of valuation of the properties transferred would create costly administrative problems if the exchange were taxed; nonrecognition is an efficient solution to the administrative difficulty.<sup>19</sup> Like the continuity of interest and

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12. See, e.g., *Eisner v. Macomber*, 252 U.S. 189 (1920) (stock dividend does not involve realization and therefore may not be taxed). See generally D. GAFFNEY, D. SKADDEN & J. WHEELER, *PRINCIPLES OF FEDERAL INCOME TAXATION* 4-5 to -7 (1982) (defining realization for tax purposes); W. KLEIN, *POLICY ANALYSIS OF THE FEDERAL INCOME TAX, TEXT AND READINGS* 74-75 (1976) (quoting Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1129-31 (1974)) (value of deferral in realization and nonrecognition); C. MCCARTHY, B. MANN, B. ABBIN, W. GREGORY & J. LINDGREN, *THE FEDERAL INCOME TAX, ITS SOURCES AND APPLICATIONS* §§ 3.24-27 (1968) (effect of realization doctrine on difference between capital and income).

13. *Starker v. United States*, 602 F.2d 1341, 1352 (9th Cir. 1979).

14. I.R.C. § 1001 (1976).

15. *Starker v. United States*, 602 F.2d 1341, 1352 (9th Cir. 1979); *Levine*, *supra* note 5, at 149; see *Carlton v. United States*, 385 F.2d 238, 241 (5th Cir. 1967).

16. *Starker v. United States*, 602 F.2d 1341, 1352 (9th Cir. 1979); *Smith v. Commissioner*, 34 T.C.M. (CCH) 704, 706 (1975); see *Carlton v. Commissioner*, 385 F.2d 238, 241 (5th Cir. 1967).

17. I.R.C. § 1001 (1976); see *Starker v. United States*, 602 F.2d 1341, 1352 (9th Cir. 1979); *Levine*, *supra* note 5, at 149.

18. *Starker v. United States*, 602 F.2d 1341, 1352 (9th Cir. 1979); *Century Elec. Co. v. Commissioner*, 192 F.2d 155, 159 (8th Cir. 1951); *Godine v. Commissioner*, 36 T.C.M. (CCH) 1595, 1597 (1977).

19. H.R. REP. NO. 704, 73d Cong., 2d Sess. (1934), *reprinted in* 1939-1 C.B. (Pt. 2) 554, 563-65.

illiquidity concepts, however, the notion of avoiding valuation does not conclusively explain the enactment of section 1031(a). Because the transfer of even one dollar in addition to the like-kind properties forces a valuation to determine the amount of gain or loss realized,<sup>20</sup> avoidance of valuation apparently was not of paramount concern to Congress.<sup>21</sup> In sum, Congress's reasons for conferring nonrecognition upon like-kind exchanges remain a mystery.

## II. THE EXCHANGE REQUIREMENT—THE STANDARDS

Despite the lack of a clear legislative purpose for section 1031, the courts have recognized that a fundamental prerequisite to a valid section 1031 transaction is the occurrence of an exchange, rather than a cash sale and reinvestment of the sale proceeds.<sup>22</sup> Ultimate receipt by the taxpayer of like-kind property is not in itself sufficient.<sup>23</sup> The line of demarcation between an exchange and a sale and reinvestment, however, is not clear.<sup>24</sup> The Treasury Department and the courts have traditionally defined an exchange as "a reciprocal transfer of property—the act of giving or taking

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20. I.R.C. § 1001(b) (1976). The amount of gain realized must be determined for reporting purposes even though the increase in the value of the property may clearly cause the entire amount of boot received to be recognized as gain on the transaction.

21. *Starker v. United States*, 602 F.2d 1341, 1352 (9th Cir. 1979); *Levine, supra* note 5, at 149.

22. *Carlton v. United States*, 385 F.2d 238, 241 (5th Cir. 1967); *Allen v. Commissioner*, 43 T.C.M. (CCH) 1045, 1046 (1982); *Meadows v. Commissioner*, 42 T.C.M. (CCH) 611, 612 (1981); *Milbrew, Inc. v. Commissioner*, 42 T.C.M. (CCH) 1467, 1489 (1981); *Barker v. Commissioner*, 74 T.C. 555, 560-61 (1980); R. GOODMAN, REAL PROPERTY EXCHANGES §§ 2.17-19 (G. Graham ed. 1982); *Duhl, supra* note 5, at 953.

23. In *Brauer v. Commissioner*, 74 T.C. 1134 (1980), the taxpayer desired to exchange his farm for another in order to avoid capital gains tax. The prospective purchaser of the taxpayer's property acquired an option on farmland suitable to the taxpayer. Due to unforeseen circumstances, however, the prospective purchaser could not complete the exchange and instead transferred the option and cash to the taxpayer, who used the cash to exercise the option and acquire the desired property. The Tax Court held that the fact the farms were of like kind was not sufficient. It was necessary that there be an "exchange" of like-kind property. *Id.* at 1139-40; see *Halpern v. United States*, 286 F. Supp. 255, 257 (N.D. Ga. 1968); *Gibson v. Commissioner*, 44 T.C.M. (CCH) 168, 170 (1982).

Three types of transactions occur, however, in which the Code permits a sale and reinvestment to qualify for nonrecognition. These situations include the sale of a principal residence if it is replaced by another residence, I.R.C. § 1034 (1976 & Supp. V 1981); the sale of low-income rental housing to a qualifying charitable organization or tenants' union if the proceeds are reinvested within a certain time period, *id.* § 1039 (1976); and the reinvestment of insurance proceeds from the involuntary conversion of property, *id.* § 1033 (1976 & Supp. V 1981).

24. One commentator has recognized that "the shadowy distinction between a sale-purchase and an exchange causes the tax result to turn on seemingly insignificant factors." *Van Dorn, supra* note 5, at 44; see also *Barker v. Commissioner*, 74 T.C. 555, 561 (1980) (substance of sale-reinvestment transaction is "not much different" from substance of an exchange); cf. *Woodbury v. Commissioner*, 49 T.C. 180, 199 (1967) (quoting an exchange price in agreement did not necessarily indicate sale). Compare *Barker*, 74 T.C. at 566 ("[t]he conceptual distinction between an exchange qualifying for section 1031 on the one hand and a sale and reinvestment on the other is largely one of form."); with *Biggs v. Commissioner*, 69 T.C. 905, 914 (1978) ("well established principle that the substance of a transaction, rather than the form in which it is cast, ordinarily determines its tax consequences"), *aff'd*, 632 F.2d 1171 (5th Cir. 1980).

one thing in return for another,'” and “mutual giving and receiving of commodities without the intervention of money.”<sup>25</sup> Early case law therefore envisioned an exchange as an event similar to the barter transaction contemplated by Congress when it initially placed the nonrecognition provision into the Code in 1921.<sup>26</sup>

In *Carlton v. United States*<sup>27</sup> the Fifth Circuit distinguished between a sale and an exchange, stating that “[t]he very essence of an exchange is the transfer of property between owners, while the mark of a sale is the receipt of cash for the property.”<sup>28</sup> Unfortunately this definition has provided little guidance to the courts for determining the requisites of modern like-kind exchanges, which frequently give the seller a great deal of control over the sales proceeds. In applying the exchange requirement in various factual contexts, the courts have developed two tests to ascertain whether or not an exchange has occurred, the contractual interdependence doctrine and the unitary plan approach. The contractual interdependence doctrine focuses on the mutuality or reciprocity that the definition of an exchange entails.<sup>29</sup> The key to this test is that the taxpayer/transferor and the prospective purchaser of the taxpayer’s property must each transfer his own property in consideration for the property he receives.<sup>30</sup> The Service phrases the test in terms of whether the sale and repurchase are “reciprocal

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25. *Estate of Grant v. Commissioner*, 36 B.T.A. 1233, 1245 (1937). The Treasury Department requires that an exchange “be a reciprocal transfer of property.” Rev. Rul. 77-297, 1977-2 C.B. 304, 305; see *Carlton v. United States*, 385 F.2d 238, 242 (5th Cir. 1967); *Gibson v. Commissioner*, 44 T.C.M. (CCH) 168, 170 (1982); *Milbrew, Inc. v. Commissioner*, 42 T.C.M. (CCH) 1467, 1490 (1981).

26. See *supra* note 4 and accompanying text. Nonrecognition of gain or loss on the exchange of like-kind property originated with section 202(c)(1) of the Revenue Act of 1921, 42 Stat. 227, 230. Section 202(c)(1) allowed nonrecognition even with respect to exchanges of securities. Abuse of the nonrecognition provisions in security exchanges and the consequent loss of revenue caused Congress to eliminate nonrecognition treatment for security exchanges in 1924. Revenue Act of 1924, § 203, 43 Stat. 256-58; see Letter from Secretary of the Treasury A.W. Mellon to William R. Green (Jan. 23, 1923), 1939-1 C.B. (Pt. 2) 845, 846. This revision, embodied in article 1572(a) of regulation 65 (1924), was carried over into § 1031(a). For a more detailed background of the legislative history of § 1031, see Banoff & Fried, *An Analysis of Recent IRS Attempt to Narrow the Scope of the Tax-Free Like-Kind Exchange*, 51 J. TAX’N 66, 68 (1979).

27. 385 F.2d 238 (5th Cir. 1967).

28. *Id.* at 242.

29. *Coupe v. Commissioner*, 52 T.C. 394 (1969). In *Coupe* the court stated: “Of crucial importance in such an exchange is the requirement that title to the parcel transferred by the taxpayer in fact be transferred in consideration for property received.” *Id.* at 405; see *Swaim v. United States*, 651 F.2d 1066, 1071 (5th Cir. 1981); *Carlton*, 385 F.2d at 241; *Rutland v. Commissioner*, 36 T.C.M. (CCH) 40, 47 (1977); R. GOODMAN, *supra* note 22, § 2.18.

30. In *Carlton*, General Development Corporation, the prospective purchaser of the taxpayer’s property, acquired an option on property that the taxpayer desired. Instead of exercising the option and transferring the property to the taxpayer, General assigned the option to him and paid him cash sufficient to exercise the option. The court held that the transfers did not qualify for nonrecognition, basing its decision in part on the fact that General had never had title to property to offer as consideration for the taxpayer’s property. 385 F.2d at 242-43. *But cf.* *Biggs v. Commissioner*, 632 F.2d 1171, 1178 (5th Cir. 1980) (holding that direct deeding of property to taxpayer, such that purchaser of taxpayer’s property never held legal title to property received by taxpayer, was not fatal to characterization as exchange).

and mutually dependent transactions."<sup>31</sup> Thus the focus is on the contractual relationship between the two transfers. Each transfer must be contractually conditional upon the occurrence of the other transfer.<sup>32</sup> The stringency of this test has frequently led the Service to attempt to defeat nonrecognition by arguing that transactions lack contractual interdependence.<sup>33</sup>

The courts have used the contractual interdependence test infrequently, however, and generally only in disallowing tax-free exchange status.<sup>34</sup> In *Allen v. Commissioner*,<sup>35</sup> for example, the Tax Court denied nonrecognition to a taxpayer who had entered into successive transactions involving placement of sale proceeds into escrow and subsequent use of the funds to purchase other property from an outside party. Although the taxpayer ultimately obtained like-kind property, the court held that "[n]othing in the record indicates . . . that the successful completion of either transaction was a condition of the other."<sup>36</sup> The decision clearly indicates that exchange treatment would be allowed only when the individual steps in a transaction are interdependent.

A literal application of the contractual interdependence test would effectively limit the use of section 1031 to the barter form of exchange, because only in such a simplified transaction does true contractual interdependence exist.<sup>37</sup> Modern courts have recognized that exchanges often must involve more than two parties and may consist of nonsimultaneous transfers.<sup>38</sup> In formulating criteria sufficiently flexible to fit the varied forms of modern exchanges, the courts have looked to the taxpayer's overall plan for the

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31. Rev. Rul. 61-119, 1961-1 C.B. 395, 396.

32. The Service has defined "contractual interdependence" as requiring that (1) the prospective recipient of the taxpayer's property (or his agent) must transfer to the taxpayer the property to be received by him, and (2) title to the property received by the taxpayer must be transferred in consideration for the property transferred by him. *Brauer v. Commissioner*, 74 T.C. 1134, 1140 (1980).

33. See, e.g., *Redwing Carriers, Inc. v. Tomlinson*, 399 F.2d 652, 656 (5th Cir. 1968) (exchange found); *Carlton*, 385 F.2d at 243 (sale found); *Barker v. Commissioner*, 74 T.C. 555, 568 (1980) (exchange found); *Biggs v. Commissioner*, 69 T.C. 905 (1978) (exchange found), *aff'd*, 632 F.2d 1171 (5th Cir. 1980).

34. See *Carlton*, 385 F.2d at 243; *Swaim v. United States*, 79-2 U.S.T.C. (CCH) ¶ 9462, at 87,692; 45 A.F.T.R.2d (P-H) ¶ 80-578, at 80-1279 (N.D. Tex. June 11, 1979), *aff'd in part and rev'd in part*, 651 F.2d 1066 (5th Cir. 1981); *Halpern v. United States*, 286 F. Supp. 255, 259 (N.D. Ga. 1968); *Rogers v. Commissioner*, 44 T.C. 126, 136 (1965), *aff'd per curiam*, 377 F.2d 534 (9th Cir. 1967).

35. 43 T.C.M. (CCH) 1045 (1982).

36. *Id.* at 1046.

37. The contractual interdependence test also poses practical problems for taxpayers and practitioners. Many formalistic steps necessary to create mutually binding contractual obligations are impractical from a business standpoint. For instance, direct deeding forces the taxpayer to incur additional expenses and serves no useful purpose. See *infra* notes 62-67 and accompanying text.

38. See, e.g., *Starker v. United States*, 602 F.2d 1341, 1351 (9th Cir. 1979) (nonsimultaneous exchange qualifies for nonrecognition treatment); *Redwing Carriers, Inc. v. Tomlinson*, 399 F.2d 652, 655-57 (5th Cir. 1968) (transactions occurring "at or about" same time qualify as tax-free exchange); *Alderson v. Commissioner*, 317 F.2d 790, 794 (9th Cir. 1963) (three-party exchange qualifies for nonrecognition).

transfers.<sup>39</sup> The unitary plan approach requires that each transfer be "part of an integrated plan intended to effectuate an exchange of like kind properties."<sup>40</sup> The test focuses on whether the taxpayer receives like-kind property as a result of mutually related transactions.<sup>41</sup> This approach emphasizes the substance of the relationship between a series of transactions rather than the intricacies of contractual form.<sup>42</sup>

Because the focus of this approach is the taxpayer's overall plan, the courts accord great weight to the taxpayer's subjective intent to effect an exchange.<sup>43</sup> As long as the taxpayer desired to exchange his property and did not in the course of the transfers actually or constructively receive the proceeds of the sale of his property, the courts have generally allowed non-recognition.<sup>44</sup> The unitary plan approach is, therefore, considerably more favorable to the taxpayer than the contractual interdependence standard, and courts analyzing modern multiparty and nonsimultaneous exchanges have applied it liberally.<sup>45</sup> In *124 Front Street, Inc. v. Commissioner*,<sup>46</sup> for

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39. In *Biggs v. Commissioner*, 69 T.C. 905 (1978), *aff'd*, 632 F.2d 1171 (5th Cir. 1980), the court stressed the substance of the transaction rather than its form. 69 T.C. at 914. The Tax Court rejected the Service's argument that contractual interdependence between the taxpayer's transfer of his property and his receipt of replacement property was a prerequisite to a valid § 1031 exchange. *Id.* The decision focused on whether the two transfers "were interdependent parts of an overall plan." *Id.*; see *Bell Lines, Inc. v. United States*, 480 F.2d 710, 713-14 (4th Cir. 1973); *Kanawha Gas & Utils. Co. v. Commissioner*, 214 F.2d 685, 691 (5th Cir. 1954); *Milbrew, Inc. v. Commissioner*, 42 T.C.M. (CCH) 1467, 1490 (1981); *Barker v. Commissioner*, 74 T.C. 555, 564 (1980).

40. *Biggs v. Commissioner*, 69 T.C. 905, 914-15 (1978).

41. See *Biggs v. Commissioner*, 632 F.2d 1171, 1178 (5th Cir. 1980); *Kanawha Gas & Utils. Co. v. Commissioner*, 214 F.2d 685, 691 (5th Cir. 1954); *J.H. Baird Publishing Co. v. Commissioner*, 39 T.C. 608, 618 (1962); Rev. Rul. 61-119, 1961-1 C.B. 395, 396.

42. See R. GOODMAN, *supra* note 22, § 2.19.

43. *Coastal Terminals, Inc. v. United States*, 320 F.2d 333, 337 (4th Cir. 1963); *Alderson v. Commissioner*, 317 F.2d 790, 792 (9th Cir. 1963); *Smith v. Commissioner*, 34 T.C.M. (CCH) 704, 706-07 (1975); *Woodbury v. Commissioner*, 49 T.C. 180, 198-99 (1967); *J.H. Baird Publishing Co. v. Commissioner*, 39 T.C. 608, 615 (1962). Many courts, however, dispute the importance of the taxpayer's intent to effect an exchange. See, e.g., *Biggs v. Commissioner*, 632 F.2d 1171, 1176, 1178 (5th Cir. 1980) (stating that intent "is not dispositive" but emphasizing taxpayer's intent nevertheless); *Hayden v. United States*, 82-2 U.S.T.C. (CCH) ¶ 9604, at 85,196 (D. Wyo. Nov. 13, 1981) ("The intent of the taxpayer to qualify for § 1031 is irrelevant."); *Halpern v. United States*, 286 F. Supp. 255, 257 (N.D. Ga. 1968) ("[i]t is legally irrelevant that the taxpayer-plaintiff intended to devise a transaction which would bring him within the letter of the statute." (emphasis in original)); *Barker v. Commissioner*, 74 T.C. 555, 564 (1980) ("While intent alone is not sufficient . . . it is relevant to a determination of what transpired."); *Godine v. Commissioner*, 36 T.C.M. (CCH) 1595, 1598 (1977) ("What actually occurred must control, and not the mere motives or intent of the parties.").

44. *Bell Lines, Inc. v. United States*, 480 F.2d 710, 713 (4th Cir. 1973); *Barker v. Commissioner*, 74 T.C. 555, 564 (1980); *Coupe v. Commissioner*, 52 T.C. 394, 409 (1969); Rev. Rul. 77-297, 1977-2 C.B. 304, 305.

45. In *Starker v. United States*, 602 F.2d 1341 (9th Cir. 1979), the court refused to apply § 1031 strictly pursuant to the language of Treas. Reg. § 1.1002-1(b) (1957). That regulation provides that "[n]onrecognition is accorded by the Code only if the exchange is one which satisfies both (1) the specific description in the Code of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule." Treas. Reg. § 1.1002-1(b) (1957). The court recognized that there has been a "long line of cases liberally construing section 1031," indicating that the regulation had been rejected. 605 F.2d at 1352; see *infra* text accompanying notes 84-87.

46. 65 T.C. 6 (1975).



example, the prospective purchaser advanced funds to the taxpayer to enable the taxpayer to exercise its option on the property desired by the prospective purchaser. The taxpayer then exchanged properties with the prospective purchaser. The court construed the transaction liberally, holding that the taxpayer had not sold its option to the prospective purchaser "but rather [had] a valid plan to exchange properties."<sup>47</sup> The taxpayer's intent to execute an exchange is, therefore, of paramount importance under the unitary plan approach.

### III. THE STANDARDS APPLIED: TRAPS FOR THE UNWARY

Although the contractual interdependence and unitary plan approaches appear uncomplicated, application of these concepts to modern exchanges involves many practical and theoretical problems. The difficulty in most cases of locating a transferee who desires to acquire the taxpayer's property and who also possesses property appealing to the taxpayer has generally limited barter as a realistic form of transaction.<sup>48</sup> Consequently, modern property owners designed multiparty and nonsimultaneous exchanges to remedy this difficulty, and these forms now constitute the norm in exchange transactions.<sup>49</sup>

#### A. Multiparty Exchanges

A multiparty exchange involves three or more parties in a complex web of transfers.<sup>50</sup> For example, a so-called "four-corner exchange" includes the taxpayer/transferor, a prospective purchaser of the taxpayer's property, a prospective seller of the replacement property, and an escrow agent. In a simultaneous four-corner transaction the escrow agent receives the cash purchase price from the prospective purchaser of the taxpayer's property. He then pays the money over to the prospective seller of the replacement property, receives the taxpayer's title in exchange for title to the replacement property, and transfers title to the taxpayer's old property to the prospective purchaser.<sup>51</sup> Although the series of transfers may not in-

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47. *Id.* at 15.

48. See Campbell, *Real Estate Investment Planning Enhanced By the Code's Tax-Free Exchange Provisions*, 19 TAX'N FOR ACCT. 20, 20-21 (1977); *Taxfree Exchanges Under Section 1031*, TAX MGMT. (BNA) No. 61-4th, at A-15 (1982).

49. See Duhl, *supra* note 5, at 951.

50. See, e.g., *Hayden v. United States*, 82-2 U.S.T.C. (CCH) ¶ 9604, at 85,197 (D. Wyo. Nov. 13, 1981); *Wagensen v. Commissioner*, 74 T.C. 653, 660 (1980); *Biggs v. Commissioner*, 69 T.C. 905, 913 (1978), *aff'd*, 632 F.2d 1171 (5th Cir. 1980); *Godine v. Commissioner*, 36 T.C.M. (CCH) 1595, 1598 (1977); *Coupe v. Commissioner*, 52 T.C. 394, 405 (1969); *Mercantile Trust Co. v. Commissioner*, 32 B.T.A. 82, 86 (1935). A round-robin exchange involving three parties and three separate properties received IRS approval in Rev. Rul. 57-244, 1957-1 C.B. 247, 248. Exchanges involving as many as 23 separate properties have been reported. See Duhl, *supra* note 5, at 951 n.13; *Chi. Tribune*, Aug. 17, 1980, § 14, at 2.

51. See generally R. GOODMAN, *supra* note 17, § 2.25 (pointing out factors of agency relationship); Duhl, *supra* note 5, at 951-54 (describing satisfactory multiparty exchanges). In *Biggs v. Commissioner*, 69 T.C. 905 (1978), *aff'd*, 632 F.2d 1171 (5th Cir. 1980), for example, the taxpayer's attorney acted as "agent for [the] syndicate" in purchasing the replacement property from an outside party with funds provided by the purchaser of the taxpayer's

terrelate contractually and would therefore fail the contractual interdependence test, the overall scheme is an exchange of like-kind properties that should normally qualify for tax-free exchange treatment under the unitary plan approach.<sup>52</sup>

The transfers in a multiparty exchange may nevertheless be disqualified from nonrecognition if the escrow agent is deemed to be the taxpayer's agent.<sup>53</sup> In such a case the escrow party's actual or constructive receipt of cash is imputed to the taxpayer.<sup>54</sup> The courts have gone to great lengths, however, to avoid disqualification of tax-free exchanges because of actual or constructive receipt by the escrow agent.<sup>55</sup> In *Coupe v. Commissioner*<sup>56</sup> the taxpayer desired to enter into a like-kind exchange, but could not reach an agreement with the transferee. The taxpayer and his attorney therefore devised a scheme by which the attorney received the proceeds from the transferee, purchased the desired property, and exchanged it for the taxpayer's property. The court held that the taxpayer's attorney, by receiving the sales proceeds and purchasing the replacement property, acted as agent for the transferee but not as agent for the taxpayer-transferor.<sup>57</sup> This questionable factual finding resulted in avoidance of constructive receipt of the sales proceeds by the taxpayer so that section 1031 applied to the transaction.

Other courts have held that a corporation controlled by the taxpayer's attorney and his family<sup>58</sup> and even a corporation controlled by the taxpayer<sup>59</sup> are not agents of the taxpayer. Generally, escrow and real estate agents are not deemed to be agents of the transferor if they are subject to some risk of loss and have some opportunity to profit from the transaction.<sup>60</sup> In the case most favorable to the taxpayer the prospective pur-

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property. 69 T.C. at 908. The attorney then exchanged this property for the taxpayer's property, which was then deeded to the purchaser. The transaction thus involved four parties: the taxpayer, the purchaser of the taxpayer's property, the taxpayer's attorney, and the seller of the property that the taxpayer desired.

52. See *supra* notes 39-42 and accompanying text.

53. See *W.D. Haden Co. v. Commissioner*, 165 F.2d 588, 592 (5th Cir. 1948); *Mays v. Campbell*, 246 F. Supp. 375, 377 (N.D. Tex. 1965); *Rutland v. Commissioner*, 36 T.C.M. (CCH) 40, 48 (1977); *J. H. Baird Publishing Co. v. Commissioner*, 39 T.C. 608, 616 (1962); Rev. Rul. 77-297, 1977-2 C.B. 304, 305; Rev. Rul. 72-151, 1972-1 C.B. 225, 225; *Van Dorn*, *supra* note 3, at 49-51; *Taxfree Exchanges Under Section 1031*, *supra* note 48, at A-16.

54. As early as 1935 the Service in *Mercantile Trust Co. v. Commissioner*, 32 B.T.A. 82 (1935), argued that a title company acted as the transferor's agent in receiving cash from the transferee and purchasing replacement property. The Board of Tax Appeals rejected this theory because the purchase agreement was enforceable against the company as a principal. *Id.* at 85; see R. GOODMAN, *supra* note 22, § 2.25; *Taxfree Exchanges Under Section 1031*, *supra* note 48, at A-16. The doctrine of constructive receipt is codified in Treas. Reg. § 1.451-2 (1982).

55. See R. GOODMAN, *supra* note 22, § 2.25; *Van Dorn*, *supra* note 5, at 45-50.

56. 52 T.C. 394 (1969).

57. *Id.* at 406.

58. *Biggs v. Commissioner*, 632 F.2d 1171, 1178 (5th Cir. 1980).

59. *Mays v. Campbell*, 246 F. Supp. 375, 377 (N.D. Tex. 1965); *Rutland v. Commissioner*, 36 T.C.M. (CCH) 40, 47 (1977).

60. See *J.H. Baird Publishing Co. v. Commissioner*, 39 T.C. 608, 616-17 (1962); Rev. Rul. 77-297, 1977-2 C.B. 304, 305; Rev. Rul. 75-291, 1975-2 C.B. 332, 333. In *J. H. Baird Publishing Co. v. Commissioner* a realty company purchased land desired by the taxpayer as

chaser would engage an escrow or real estate agent to purchase the replacement property and transfer it to the taxpayer in exchange for his property. The prospective purchaser may, however, be unwilling to enter into such an arrangement.<sup>61</sup> As in *Coupe*, the taxpayer himself must then engage someone to handle the exchange and risk a finding of agency or constructive receipt, either of which would defeat nonrecognition treatment.

Direct deeding of the replacement property from the prospective seller to the taxpayer-transferor is a second factor that creates conceptual difficulties for the courts.<sup>62</sup> The parties may choose direct deeding to avoid local transfer taxes and other costs, eliminating the prospective purchaser and the escrow agent from the transfer altogether. The problem with a direct transfer is that the taxpayer-transferor does not receive like-kind property from the party to whom he transferred his own property.<sup>63</sup> No exchange of property with the prospective purchaser of the taxpayer's property occurs, because the prospective purchaser does not transfer any property to the taxpayer.<sup>64</sup> A court applying the contractual interdependence test would deny nonrecognition treatment in a case of direct deeding because the taxpayer does not receive property in consideration for the property he transfers.<sup>65</sup> Recent cases, however, have accepted direct deeding as a practical necessity, looking beyond legal form to the substance of the transaction in determining whether an exchange actually occurred.<sup>66</sup> Nevertheless, the issue of direct deeding is not entirely moot, because courts applying the unitary plan approach to the exchange requirement

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a replacement building site and constructed a building thereon to the taxpayer's specifications. The court found that the realty company carried out these activities on its own behalf and not as an agent for the taxpayer. 39 T.C. at 617. The court noted that under the terms of the agreement with the taxpayer the realty company bore some of the taxes and fees with respect to the replacement property during the construction period and that such burdens of ownership belied the status of mere agent. *Id.*

61. See *Alderson v. Commissioner*, 317 F.2d 790, 795 (9th Cir. 1963); *Coupe v. Commissioner*, 52 T.C. 394, 406 (1969); *Mercantile Trust Co. v. Commissioner*, 32 B.T.A. 82, 85 (1935).

62. The IRS has frequently attacked exchanges that do not employ pass-through deeds, in which the purchaser of the taxpayer's property temporarily holds title to the replacement property. See, e.g., *Carlton v. United States*, 385 F.2d 238, 239-40 (5th Cir. 1967); *Alderson v. Commissioner*, 317 F.2d 790, 794-95 (9th Cir. 1963); *W.D. Haden Co. v. Commissioner*, 165 F.2d 588, 590 (5th Cir. 1948); *Meadows v. Commissioner*, 42 T.C.M. (CCH) 611, 612 (1981); *Brauer v. Commissioner*, 74 T.C. 1134, 1140, 1144-45 (1980); *Biggs v. Commissioner*, 69 T.C. 905, 914-15 (1978), *aff'd*, 632 F.2d 1171 (5th Cir. 1980); Rev. Rul. 57-244, 1957-1 C.B. 247.

63. *Rogers v. Commissioner*, 44 T.C. 126, 135-36 (1965).

64. *Meadows v. Commissioner*, 42 T.C.M. (CCH) 611, 612 (1981).

65. *Carlton v. United States*, 385 F.2d 238 (5th Cir. 1967), is a prime example of the contractual interdependence test's requirement of a pass-through deed. See *supra* note 30.

66. The Fifth Circuit has recently unequivocally allowed direct deeding of the exchange property. *Biggs v. Commissioner*, 632 F.2d 1171, 1175-77 (5th Cir. 1980). The *Biggs* decision apparently overrules the Fifth Circuit's holding in *Carlton v. United States*, 385 F.2d 238, 242-43 (5th Cir. 1967), that direct deeding disqualifies an exchange, although the *Carlton* decision turned in part on the taxpayer's receipt of cash. The Tax Court has consistently permitted direct deeding. See, e.g., *Barker v. Commissioner*, 74 T.C. 555, 566-67 (1980); *Brauer v. Commissioner*, 74 T.C. 1134, 1146 (1980).

consider the pattern of deed transfers as indicative of the taxpayer's overall plan.<sup>67</sup>

A third potential pitfall of section 1031 concerns the means of selecting exchange property. In multiparty exchanges the taxpayer often actively looks for and negotiates the purchase of replacement property because the buyer of the taxpayer's property is unwilling or unable to take on such responsibility.<sup>68</sup> As the taxpayer's participation in the acquisition process increases, the transaction increasingly resembles a sale and repurchase rather than an exchange, particularly if cash enters the transaction via an escrow account or other security arrangement.<sup>69</sup> In *Alderson v. Commissioner*<sup>70</sup> the court held that the transferee must actually purchase the exchange property, although the taxpayer may engage in extensive negotiations for its purchase.<sup>71</sup> Evidently the sole restriction is that the taxpayer may not actually sign the purchase and sale agreement on the replacement property.<sup>72</sup> Form rather than substance is thus of paramount importance in this aspect of the exchange transaction.

Another conceptual difficulty associated with multiparty exchanges concerns the taxpayer's option to receive cash should the exchange agreement fail. Courts have generally held that the option to receive cash in lieu of like-kind property should the exchange agreement fall through does not invalidate the tax-free status of the exchange if an exchange in fact took place and the taxpayer intended from the beginning to receive like-kind property.<sup>73</sup> The courts have thus properly exalted substance over form in this regard, looking to what actually happened rather than to the terms of

67. See, e.g., *Meadows v. Commissioner*, 42 T.C.M. (CCH) 611, 612 (1981) (although transaction clearly involved sale and exchange, court focused on pattern of deed transfers).

68. See *Biggs v. Commissioner*, 632 F.2d 1171, 1173-74 (5th Cir. 1980); *Coastal Terminals, Inc. v. United States*, 320 F.2d 333, 334-35 (4th Cir. 1963); *W.D. Haden Co. v. Commissioner*, 165 F.2d 588, 590 (5th Cir. 1948); *Rutland v. Commissioner*, 36 T.C.M. (CCH) 40, 46 (1977); *Borchard v. Commissioner*, 24 T.C.M. (CCH) 1643, 1647-48 (1965); Rev. Rul. 75-291, 1975-2 C.B. 333; G. ROBINSON, FEDERAL INCOME TAXATION OF REAL ESTATE, TEXT, FORMS AND TAX PLANNING IDEAS ¶ 12.04[2][a] (3d ed. 1979); Campbell, *supra* note 48, at 22-24.

69. The courts have, however, allowed taxpayers wide latitude in locating and financing the purchase of the replacement property. In *Rutland v. Commissioner*, 36 T.C.M. (CCH) 40 (1977), the taxpayer handled all negotiations with respect to acquiring replacement property, including "the purchase price, the terms of the transaction, the manner in which title was to be conveyed and when the transaction was to be closed." *Id.* at 46. The court allowed tax-free exchange treatment, noting that the taxpayer did not actually purchase the exchange property but left this final step to the purchaser of his property. *Id.* at 47.

70. 317 F.2d 790 (9th Cir. 1963).

71. *Id.* at 795; see *Rutland v. Commissioner*, 36 T.C.M. (CCH) 40, 46 (1977); *Mercantile Trust Co. v. Commissioner*, 32 B.T.A. 82, 86 (1935).

72. See *Carlton v. United States*, 385 F.2d 238, 242-43 (5th Cir. 1967); *Alderson*, 317 F.2d at 795; *Mercantile Trust Co. v. Commissioner*, 32 B.T.A. 82, 85 (1935).

73. *Coupe v. Commissioner*, 52 T.C. 394, 405 (1969). The court stated:

It is now well settled that when a taxpayer who is holding property for productive use in a trade or business enters into an agreement to sell the property for cash, but before there is substantial implementation of the transaction, arranges to exchange the property for other property of like kind, he receives the nonrecognition benefits of section 1031.

*Id.*; *Starker v. United States*, 602 F.2d 1341, 1354 (9th Cir. 1979); *Coastal Terminals, Inc. v. United States*, 320 F.2d 333, 335 (4th Cir. 1963); *Alderson*, 317 F.2d at 792.

the exchange contract to determine the tax consequences of the transaction.<sup>74</sup>

The final problem area in multiparty exchanges is the relatively short time during which the prospective purchaser of the taxpayer's property holds title to the like-kind exchange property. Whether the prospective purchaser is the ultimate purchaser or merely an escrow agent purchasing for another buyer, such party normally holds title to the property the taxpayer desires only momentarily because he usually purchases the like-kind property for the sole purpose of exchanging it with the taxpayer. Although the prospective purchaser does not assume the burdens and benefits of owning the replacement property, the courts generally have permitted non-recognition on exchange transactions despite such temporary ownership.<sup>75</sup> The courts' deference in this area thus takes into account the purchaser's business-related need for temporary ownership of the replacement property.

The courts, therefore, have applied the exchange requirement liberally in cases involving multiparty transactions.<sup>76</sup> Use of the intent-focused unitary plan approach has substantially mitigated the harshness of the contractual interdependence test. Nonetheless, the conceptual difficulties of multiparty exchanges remain for the courts and tax practitioners. The further an exchange strays from the traditional barter model the greater the likelihood that a court will reclassify it as a sale and reinvestment transaction.<sup>77</sup> Thus the practitioner structuring a multiparty transaction should be aware of the doctrine of constructive receipt, particularly as it interacts with the concept of agency. If the parties employ an escrow account they should consider placing substantial restrictions on the taxpayer's access to

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74. *Mercantile Trust Co. v. Commissioner*, 32 B.T.A. 82, 86-87 (1935). The IRS has acquiesced in this approach. Rev. Rul. 77-297, 1977-2 C.B. 304, 305.

75. In *Alderson v. Commissioner*, 317 F.2d 790 (9th Cir. 1963), the court held that the prospective purchaser "need not assume the benefits and burdens of ownership in property before exchanging it but may properly acquire title *solely for the purpose of exchange*. . . ." *Id.* at 795 (emphasis in original); see *Coastal Terminals, Inc. v. United States*, 320 F.2d 333, 336 (4th Cir. 1963); *Barker v. Commissioner*, 74 T.C. 555, 562 (1980); *Rutland v. Commissioner*, 36 T.C.M. (CCH) 40, 48 (1977); *Mercantile Trust Co. v. Commissioner*, 32 B.T.A. 82, 83 (1935). Where the prospective purchaser acquires title to the replacement property for the purpose of exchange, the exchange qualifies for nonrecognition as to the taxpayer, but any gain or loss to the prospective purchaser is recognized. Rev. Rul. 75-291, 1975-2 C.B. 333. The reason for this seemingly inconsistent treatment is that the prospective purchaser has not held the exchanged property "in trade or business or for investment" as required by § 1031. *Id.*

76. The Tax Court demonstrated the liberal nature of the result-oriented unitary plan test in *Biggs v. Commissioner*, 69 T.C. 905, 914-15 (1978), *aff'd*, 632 F.2d 1171 (5th Cir. 1980). The court stated that it had found in *Coupe* "that the statute requires only that, as the end result of an agreement, property is received as consideration for property transferred by the taxpayer." 69 T.C. at 916 (citing *Coupe v. Commissioner*, 52 T.C. 394, 409 (1969)).

77. In *Barker v. Commissioner*, 74 T.C. 555 (1980), the court warned taxpayers and practitioners that "[n]otwithstanding those deviations from the standard multiple-party exchanges which have received judicial approval, at some point the confluence of some sufficient number of deviations will bring about a taxable result. . . . [T]axpayers who stray too far run the risk of having their transactions characterized as a sale and reinvestment." *Id.* at 563-64.

the sales proceeds in the account.<sup>78</sup> Additionally, the exchange should provide for a pass-through deed, whereby the purchaser of the taxpayer's property temporarily holds title to the replacement property, in order to avoid a claim by the Service that the exchange failed because of direct deeding. Finally, although the courts have allowed the taxpayer wide latitude in negotiating for the purchase of exchange property, the taxpayer should not enter into a sale and purchase contract with the prospective seller, but rather should leave this final step to the prospective purchaser.

### B. Nonsimultaneous Exchanges

The nonsimultaneous exchange, a relative newcomer among section 1031 exchanges,<sup>79</sup> also contains procedural elements that may prevent nonrecognition. The Ninth Circuit Court of Appeals in *Starker v. United States*<sup>80</sup> formally discussed the nonsimultaneous exchange for the first time. In *Starker* the taxpayer transferred a large block of property to Crown Zellerbach in return for the corporation's promise, evidenced by a bookkeeping entry, to purchase replacement property designated by the taxpayer within five years of the transfer. If the taxpayer failed to designate a sufficient amount of property within the five-year period, Crown Zellerbach was to pay the balance of the account in cash at the end of that period.

The *Starker* court discussed in detail the conceptual difficulties inherent in the nonsimultaneous exchange. The court noted two aspects of nonsimultaneous exchanges that might cause disallowance of preferred tax status.<sup>81</sup> First, the court examined the possibility that the taxpayer might receive cash sometime in the future. The court recognized that it had considered this question previously in the multiparty exchange cases.<sup>82</sup> The court found, as a matter of well-settled law, that the possibility of receiving cash in the future did not prevent section 1031 from applying, as long as the taxpayer intended from the outset to receive only like-kind property and in fact did not receive cash during the course of the transaction.<sup>83</sup>

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78. See *Barker v. Commissioner*, 74 T.C. 555, 567-68 (1980); *Brauer v. Commissioner*, 74 T.C. 1134, 1137-38 (1980); see Rev. Rul. 77-297, 1977-2 C.B. 304.

79. One commentator declares that "[u]ntil *Starker*, there was no express authority for the proposition that Section 1031 . . . could involve nonsimultaneous transfers of property." Welch, *New Case Permits Long Delay in Completing Nontaxable Exchanges of Like-Kind Property*, 24 TAX'N FOR ACCT. 74, 74 (1980) (footnote omitted). Nonsimultaneity of exchange tacitly existed, however, in many qualified exchanges prior to the decision in *Starker v. United States*, 602 F.2d 1341 (9th Cir. 1979). See *Redwing Carriers, Inc. v. Tomlinson*, 399 F.2d 652, 658-59 (5th Cir. 1968); *Carlton v. United States*, 385 F.2d 238, 240 (5th Cir. 1967); *Godine v. Commissioner*, 36 T.C.M. (CCH) 1595, 1597-98 (1977); *Woodbury v. Commissioner*, 49 T.C. 180, 198-99 (1967); *J.H. Baird Publishing Co. v. Commissioner*, 39 T.C. 608, 618 (1962); *Horne v. Commissioner*, 5 T.C. 250, 255 (1945).

80. 602 F.2d 1341 (9th Cir. 1979).

81. *Id.* at 1353.

82. *Id.* at 1353-54; see *supra* notes 73-74 and accompanying text.

83. 602 F.2d at 1354. The court stated unequivocally that "the mere possibility at the time of agreement that a cash sale might occur does not prevent the application of section 1031." *Id.*; cf. *Carlton v. United States*, 385 F.2d 238, 239 (5th Cir. 1967), concerning a

The *Starker* court also considered whether the nonsimultaneous nature of the transaction should disqualify the exchange.<sup>84</sup> The government argued that section 1.1002-1(b) of the Treasury Regulations required simultaneity;<sup>85</sup> that regulation provides that all exceptions to the general rule of recognition of gain or loss on the disposition of property are to be construed narrowly.<sup>86</sup> After reviewing past litigation concerning section 1031, however, the court found that other courts had construed the statute liberally in favor of nonrecognition.<sup>87</sup> The court therefore expressed doubt as to whether the regulation had any continuing application to tax-free exchanges.<sup>88</sup>

The Fifth Circuit Court of Appeals in *Redwing Carriers, Inc. v. Tomlinson*<sup>89</sup> had previously recognized that nonsimultaneity of exchange did not convert an exchange into a sale.<sup>90</sup> In *Redwing* the taxpayer claimed that a sale of used trucks to a dealer, followed several days later by a purchase of new trucks from the same dealer, constituted a sale and repurchase such that a loss on the sale should have been recognized. The court disagreed, holding that the two transactions were contractually interdependent and, therefore, merely steps in an exchange of like-kind properties.<sup>91</sup> Thus the court required exchange treatment even though the transfers were not simultaneous.<sup>92</sup>

Although the *Starker* court did not specifically discuss the method of securing a buyer's obligation to transfer property to the taxpayer in the future, the means employed may cause constructive receipt of cash by the taxpayer, thus disqualifying the exchange.<sup>93</sup> In *Starker* constructive re-

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nonsimultaneous exchange involving an option to receive cash. The court in *Carlton* denied exchange treatment because the taxpayer actually received cash. 385 F.2d at 241-43.

84. 602 F.2d at 1354-55.

85. Treas. Reg. § 1.1002-1(b) (1957).

86. *Id.*; see *supra* note 45.

87. 602 F.2d at 1352-53. The court cited *Biggs v. Commissioner*, 69 T.C. 905 (1978), *aff'd*, 632 F.2d 1171 (5th Cir. 1980), on this point. In *Biggs* the Tax Court reviewed various activities in which taxpayers had engaged without causing disallowances of tax-free exchange treatment. For example, the taxpayer may locate the target property and negotiate for its purchase. 69 T.C. at 913; see *supra* notes 68-71 and accompanying text. Additionally, the taxpayer may supervise improvements to the target property and deposit earnest money on such property. 69 T.C. at 913-14 (citing *124 Front Street, Inc. v. Commissioner*, 65 T.C. 6, 15-18 (1975); *J.H. Baird Publishing Co. v. Commissioner*, 39 T.C. 608, 611 (1962)).

88. 602 F.2d at 1352.

89. 399 F.2d 652 (5th Cir. 1968).

90. *Id.* at 658-59.

91. *Id.* at 659. The court found that "[t]he buying and selling were synchronous parts meshed into the same transaction and not independent transactions." *Id.* at 656. The Service had previously ruled against another taxpayer on this issue under identical facts. Rev. Rul. 61-119, 1961-1 C.B. 395, 397.

92. 399 F.2d at 659; see also *Horne v. Commissioner*, 5 T.C. 250, 254-56 (1945) (disallowing loss deduction on sale of membership certificate on future exchange where taxpayer had purchased another certificate eight days earlier); cf. I.R.C. § 1091 (1976) (disallowance of losses from wash sales of stocks or securities); I.R.C. § 1092 (Supp. V 1981) (disallowance of most losses arising from tax straddles).

93. See R. GOODMAN, *supra* note 22, §§ 5.4-.8; Berney, *How to Protect the Owner Waiting for Property in a Nonsimultaneous Exchange*, 25 TAX'N FOR ACCT. 344, 345 (1981); Welch, *supra* note 79, at 77.

ceipt was not an issue because Crown Zellerbach's obligation to the taxpayer was unsecured.<sup>94</sup> In the normal nonsimultaneous exchange, however, the taxpayer usually desires some security for the buyer's obligation. One option is to retain a security interest in the property transferred. Merely holding such an interest in like-kind property does not cause constructive receipt because the holding of the interest does not entail a potential for receiving cash.<sup>95</sup> Such an arrangement may not, however, be acceptable to the buyer, who may wish to mortgage or sell the property.<sup>96</sup> The parties may therefore arrange for the taxpayer to hold a security interest in other real property belonging to the buyer.<sup>97</sup> This form of security is disadvantageous to the taxpayer, whose security interest is then subordinate to the interests of prior secured creditors with respect to the same property.<sup>98</sup> An additional problem raised by use of the buyer's other property to secure the buyer's obligation is that the buyer may not own sufficient other real estate to serve as collateral. Parties to nonsimultaneous exchanges may therefore seek other means of securing the contract.

Escrow and trust arrangements and joint bank accounts are alternative forms of security, but they contain possible grounds for challenge by the Service because of their potential for causing cash receipt by the taxpayer. In one Revenue Ruling an escrow arrangement escaped imposition of the constructive receipt doctrine because it contained substantial restrictions on distribution of the proceeds to the taxpayer.<sup>99</sup> The Service originally allowed, in a Private Letter Ruling, an arrangement in which the proceeds from the sale of the taxpayer's property were placed in trust for the taxpayer's benefit pending acquisition of the replacement property.<sup>100</sup> The Service subsequently suspended<sup>101</sup> and then revoked<sup>102</sup> its ruling allowing such an arrangement, however, after the government's defeat in *Starker*. Joint bank accounts in the names of taxpayer and purchaser are likely to receive particular scrutiny by the Service because of their similarity to the

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94. 602 F.2d at 1343.

95. In *Starker* the government had argued that the contract right to receive property in the future was "not 'like' title to property, because it was like cash," so that § 1031 should not apply. *Id.* at 1355. The court held, however, that "title to land is no more or less equivalent to cash than a contract right to buy land." *Id.* Likewise, a security interest in the property transferred should not be treated as a cash equivalent because it represents only a contract between the parties to transfer the property in the event of default. See *Roach v. Commissioner*, 20 B.T.A. 919, 924-25 (1930) (doctrine of constructive receipt to be applied sparingly).

96. R. GOODMAN, *supra* note 22, § 5.6.

97. A charge by the Service of constructive receipt on this type of security arrangement should fail for the same reasons as the attack on the taxpayer retaining a security interest on his own property.

98. *Cf.* TEX. BUS. & COM. CODE ANN. § 9.312(e)(1) (Tex. UCC) (Vernon Supp. 1982-1983) (priority between conflicting security interests in same collateral personal property determined by time of filing or perfection of security interest).

99. Rev. Rul. 77-297, 1977-2 C.B. 304. The Regulations provide that "income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions." Treas. Reg. § 1.451-2(a) (1964); see T.D. 6723, 1964-1 C.B. 73, 74.

100. Ltr. Rul. 7938087 (June 22, 1979).

101. Ltr. Rul. 8005049 (Nov. 8, 1979).

102. Ltr. Rul. 8046122 (Aug. 25, 1980).



receipt of cash. A requirement that both taxpayer and purchaser sign for withdrawals from such an account may overcome the constructive receipt issue,<sup>103</sup> but the Service has not declared its position in this area.

The nonsimultaneous exchange therefore poses conceptual difficulties for the courts and practical difficulties for the taxpayer, particularly in regard to securing the buyer's obligation. The court in *Starker* nevertheless had little difficulty in determining that the potential receipt of cash by the taxpayer should the agreement to exchange fail did not disqualify the exchange.<sup>104</sup> In almost summary fashion the *Starker* court also dismissed the government's argument that the nonsimultaneous nature of the transaction disqualified the exchange.<sup>105</sup> This decision is consistent with the current judicial attitude allowing great flexibility in structuring section 1031 exchanges.<sup>106</sup> Under the unitary plan approach transfers such as the *Starker* exchange merit nonrecognition because their ultimate result, an exchange, is what the taxpayer intended from the start despite the complex means used to reach it.<sup>107</sup> The *Starker* court noted that nonsimultaneous exchanges pose grave administrative difficulties for the courts and the Service,<sup>108</sup> but declined to confront these issues, leaving that task instead to Congress and the Service.<sup>109</sup> It is clear, therefore, that the nonsimultaneous exchange will continue to be susceptible to government challenges on the ground that it transgresses the permissible bounds of a true exchange, causing constructive or actual receipt of cash that may not escape recognition.<sup>110</sup>

#### IV. A STATUTORY SOLUTION

Attempts by the courts to explain Congress's intent in passing section 1031, while revealing general opposition to the taxing of events that do not involve recognized accessions to wealth,<sup>111</sup> have failed to define satisfacto-

103. See R. GOODMAN, *supra* note 22, § 5.8.

104. See *supra* notes 82-83 and accompanying text.

105. See *supra* notes 84-88 and accompanying text.

106. See *supra* note 87.

107. *Starker*, 602 F.2d at 1354.

108. *Id.* at 1356. The court did not specify the administrative problems that nonsimultaneous exchanges might cause.

109. *Id.* The court stated:

Some administrative difficulties may surface . . . . Our role, however, is not necessarily to facilitate administration. It is to divine the meaning of the statute in a manner as consistent as possible with the intent of Congress and the prior holdings of the courts. If our holding today adds a degree of uncertainty to this area, Congress can clarify its meaning.

*Id.*

110. See, e.g., *Swaim v. United States*, 651 F.2d 1066 (5th Cir. 1981). In *Swaim* the court found that the taxpayers had actually received cash and cash equivalents, so that the return of the consideration to the buyer several months later failed to achieve a tax-free exchange. *Id.* at 1071.

111. See *United States v. Kaiser*, 363 U.S. 299, 303-04 (1960) (strike benefits held gift, not taxable income); see also *Commissioner v. Kowalski*, 434 U.S. 77, 83 (1977) (accession to wealth occurred); *James v. United States*, 366 U.S. 213, 219 (1961) (accession to wealth if actual command over property and no recognition of obligation to repay); *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955) (accession to wealth doctrine enunciated).

rily the specific reasons for the statute's discrimination between exchanges and sale and reinvestment transactions. The taxpayer's basic economic position does not change in either case. Clearly, however, Congress meant section 1031 to apply only when the taxpayer continues in the same general business or investment by means of an exchange.<sup>112</sup> As long as the taxpayer's fortune remains tied to like-kind property, the exchange should not be taxed,<sup>113</sup> but once the investment is converted, even temporarily, into cash or property other than like-kind property the transaction loses its exchange character and should be taxed. The *Starker* court disregarded this principle. In summarily disposing of the issue of nonsimultaneity, the court failed to note that the proceeds from the sale of the taxpayer's property were no longer invested in like-kind property. Instead, the taxpayer's investment had become a fixed money amount and no longer depended on the economics of the real estate market.<sup>114</sup> The transaction in *Starker* thus differed from an actual exchange and fell outside the scope of Congress's presumed reasons for granting nonrecognition to exchanges.

The courts' tolerance of multiparty exchanges also indicates that they will go to great lengths to find that an exchange has occurred and that the party handling the cash proceeds is not the taxpayer's agent. As noted, even corporations controlled by the taxpayer or the taxpayer's attorney or family have been declared not to be acting as the taxpayer's agent in receiving the proceeds from the sale of the taxpayer's property and locating replacement property.<sup>115</sup> Courts applying the law of agency in other contexts would probably reach different conclusions.<sup>116</sup> The Tax Court has also gone far afield in the area of constructive receipt, holding that an advance of cash by the prospective purchaser to the taxpayer to allow him to exercise an option on the property desired by the prospective purchaser does not constitute boot to the taxpayer in measuring gain or loss recognized from the transaction and does not, therefore, disqualify the transaction from nonrecognition treatment.<sup>117</sup> The reasoning behind such a

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112. See *supra* notes 22-23 and accompanying text.

113. This notion is the crux of the continuity of interest rationale underlying section 1031. See *supra* notes 10-11 and accompanying text.

114. In *Starker* Crown Zellerbach transformed the taxpayer's investment into "exchange value credits" on the corporate books. A "growth factor" accrued on the account during the delay between the taxpayer's transfer of his property to Crown and Crown's transfer of property to the taxpayer. The court held that the "growth factor" constituted disguised interest. 602 F.2d at 1356. This conclusion is somewhat at odds with the court's holding that an exchange occurred, because interest is defined as "compensation for the use or forbearance of money," thus indicating a fixed monetary claim and not a volatile investment in real estate. *Id.*; see Duhl, *supra* note 5, at 961.

115. See *supra* notes 57-59 and accompanying text.

116. Many courts have held that the test for determining the existence of an implied agency is the right of the principal to control the conduct of the agent, or the actual exercise of such control. *Nidiffer v. Clinchfield R.R.*, 600 S.W.2d 242, 245 (Tenn. Ct. App. 1980); *True v. Hi-Plains Elevator Mach., Inc.*, 577 P.2d 991, 999 (Wyo. 1978). This test indicates that the corporation controlled by the taxpayer in *Rutland v. Commissioner*, 36 T.C.M. (CCH) 40 (1977), and the corporation controlled by the taxpayer's attorney in *Biggs v. Commissioner*, 632 F.2d 1171 (5th Cir. 1980), should have been held to be agents of the respective taxpayers.

117. *124 Front St., Inc. v. Commissioner*, 65 T.C. 6, 16 (1975).

determination is unclear.

In addition to the judicial manipulation of the exchange concept, section 1031 suffers from old age. The drafters of the statute envisioned two-party barter transactions and devised a nonrecognition provision to fit that kind of transaction.<sup>118</sup> Section 1031 does not accommodate the types of exchanges that are a common part of modern business transactions. The outmoded nature of the provision may justify overreaching by the courts to allow nonrecognition where both theory and practicality compel such treatment. The certainty and clarity needed by practitioners and taxpayers is lacking, however, when courts must update statutes on an ad hoc basis.

The maladies of section 1031 could be easily cured by eliminating its main defect, the exchange requirement itself. The nature and definition of an exchange have never been clear. Congress has avoided the exchange requirement in other nonrecognition statutes that require continuity of investment. For example, the section 1033 limitation on the time allowed for reinvestment of insurance proceeds from involuntary conversions includes no such requirement;<sup>119</sup> neither does the section 1034 time limit for reinvestment of the proceeds from the sale of a principal residence.<sup>120</sup> As a result, a taxpayer may rely on these provisions without concerning himself about such issues as constructive receipt, direct deeding, agency, momentary deed possession, and nonsimultaneity; he need only reinvest the proceeds within the appropriate time frame. The tax practitioner, therefore, may plan continuity of investment transactions under these provisions with greater certainty of achieving nonrecognition than under section 1031.

Nonrecognition provisions without an exchange requirement avoid other issues inherent in section 1031. For example, the *Starker* court did not limit the length of time a taxpayer may take to decide whether to receive cash or like-kind property without causing recognition. Can such a period extend indefinitely? If so, how is the statute of limitation<sup>121</sup> affected by a transfer of non-like-kind property more than three years after the execution of the exchange agreement? May promises to transfer like-kind property be pledged or sold, so that the taxpayer should be taxed on the constructive receipt of cash?<sup>122</sup> At present, these administrative questions have no answers, but conflicts in these areas are inevitable under the current statutory language. These conflicts can be avoided only if Congress accepts the Ninth Circuit's challenge in *Starker* and resolves the ambigu-

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118. See *supra* note 26 and accompanying text.

119. Section 1033 provides that if property is compulsorily or involuntarily converted into money, gain or loss will not be recognized if the taxpayer reinvests these funds into similar property or a controlling interest in a corporation owning similar property within two years after disposition of the converted property. I.R.C. § 1033 (1976 & Supp. V 1981).

120. Section 1034 provides that no gain will be recognized on the sale of a principal residence if the proceeds from the sale are reinvested in a new principal residence within two years from the date of sale. *Id.* § 1034 (1976 & Supp. V 1981).

121. *Id.* § 6501 (1976 & Supp. V 1981).

122. For a more detailed examination of the practical administrative problems that the *Starker* decision presents, see Duhl, *supra* note 5, at 962-63.

ties in section 1031.<sup>123</sup>

Alignment of section 1031 with other nonrecognition provisions that do not currently require an exchange would also modernize section 1031 to account for modern-day transactions. Requiring the taxpayer to execute a pass-through deed, for example, is a costly and cumbersome step that would be unnecessary in a multiparty exchange absent a formal exchange requirement.<sup>124</sup> Similarly, the purchaser of the taxpayer's property would not have to assist the taxpayer in the ritual of signing a purchase contract with the prospective seller of the replacement property and then transferring the property to the taxpayer. By requiring such formalistic steps, section 1031 exalts form over substance, a practice that the tax law should avoid.<sup>125</sup>

The advent of the unitary plan approach<sup>126</sup> to evaluating exchange transactions, with its emphasis on the form of the transaction rather than the substance, was a step in the right direction. That approach did not, however, remove all of the hidden dangers of section 1031. Until Congress steps in and revises section 1031, taxpayers and practitioners alike will frequently remain unsure that the transactions they have structured will qualify for nonrecognition treatment.

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123. See *supra* note 109 and accompanying text.

124. See *supra* notes 62-66 and accompanying text.

125. The Supreme Court stated the rule of substance over form in *Weiss v. Stearn*, 265 U.S. 242 (1924): "Questions of taxation must be determined by viewing what was actually done, rather than the declared purpose of the participants; and when applying the provisions of the Sixteenth Amendment and income laws enacted thereunder we must regard matters of substance and not mere form." *Id.* at 254; see *Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1945).

126. See *supra* notes 37-45 and accompanying text.

