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THE HOLDING REQUIREMENT OF SECTION 1031—*MAGNESON V. COMMISSIONER*

NORMAN and Beverly Magneson owned a fee simple interest in an apartment building (Iowa Street Property), held for investment within the meaning of Internal Revenue Code section 1031(a).¹ N.E.R. Plaza, Ltd., a California limited partnership, owned commercial property known as the Plaza Property. In the first step of a prearranged transaction the Magnesons exchanged their fee interest in the Iowa Street Property for a ten percent undivided interest in the Plaza Property. The Magnesons then exchanged their interest in the Plaza Property for a general partnership interest in U.S. Trust, Ltd., a California limited partnership.² The general partnership interest consisted of a ten percent equity interest and a nine percent interest in the net profits and losses of U.S. Trust. U.S. Trust acquired the remaining ninety percent undivided interest in the Plaza Property on the same day. Based on the nonrecognition provision of section 1031(a), the Magnesons did not pay taxes on the gain realized from the exchange of their Iowa Street Property for the Plaza Property.³ Furthermore, the Magnesons claimed nonrecognition treatment under section 721⁴ for their contribution of their Plaza Property interest to U.S. Trust and, accordingly, paid no tax on the realized gain from that transaction.⁵

The Commissioner determined a deficiency in the Magnesons' 1977 federal income tax return, asserting that the exchange of the Iowa Street Property for the Plaza Property did not qualify for nonrecognition under section 1031(a). The Service stated that the Magnesons failed to hold the Plaza Property for investment⁶ as required by section 1031(a). The Magnesons

1. I.R.C. § 1031(a) (1954, as amended through 1977). Section 1031(a) provides in part: "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." The Magnesons' use of the property for investment purposes did not constitute an issue in the case.

2. In addition to their interest in the Plaza Property, the Magnesons also contributed cash in exchange for the partnership interest in U.S. Trust.

3. The parties stipulated that the Magnesons' interest in the Iowa Street Property and the Plaza Property were like-kind properties within the meaning of § 1031(a).

4. I.R.C. § 721 (1954, as amended through 1977). This section provides that "[n]o gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership." *Id.*

5. The parties agreed that the Magnesons' contribution of their interest in the Plaza Property and cash to U.S. Trust for their general partnership interest constituted a nontaxable transaction under the provisions of I.R.C. § 721.

6. The Tax Court and the Ninth Circuit used the phrase "held for investment" throughout their opinions because the distinction between productive use and investment was not material to the case. *Magneson v. Commissioner*, 753 F.2d 1490, 1492 (9th Cir. 1985), *aff'g* 81 T.C. 767, 769 (1983).

challenged the deficiency in the Tax Court,⁷ contending that holding the property to contribute to a partnership satisfied the requisite investment purpose. The Tax Court agreed with the Magnesons and found that the contribution of the Plaza Property to U.S. Trust constituted a continuation of the Magnesons' unliquidated investment in a modified form, thus fulfilling the requirement of section 1031(a).⁸ The Ninth Circuit reviewed the Tax Court's conclusion of the law de novo. *Held, affirmed*: Property acquired in a like-kind exchange with the intention of contributing it to a general partnership in return for an interest in that partnership satisfies the holding requirement of section 1031(a) and entitles the taxpayer to nonrecognition treatment of the exchange. *Magneson v. Commissioner*, 753 F.2d 1490 (9th Cir. 1985).

I. DEVELOPMENT OF THE HOLDING REQUIREMENT OF SECTION 1031

Section 1031 represents the culmination of legislative efforts to allow nonrecognition of a paper gain or loss on an exchange of property that merely continues an investment in like-kind property.⁹ The reasoning behind section 1031 emanates from section 202(c)(1) of the Revenue Act of 1921.¹⁰ Section 202(c)(1) extended nonrecognition treatment to transactions in which a taxpayer exchanged property held for investment or productive use in business¹¹ for property categorized as like in kind or use.¹² The report of the Senate Committee on Finance explained that section 202(c)(1) purported to provide new rules for those exchanges of property in which a taxpayer realized a technical gain under the prior law without realizing an actual cash profit.¹³

Congress reconsidered the advisability of deferring gain or loss on a like-kind exchange in 1934. The legislative history underlying Congress's decision to reenact the deferral provision constitutes the source from which

7. *Magneson v. Commissioner*, 81 T.C. 767 (1983).

8. *Id.* at 771; *see infra* text accompanying notes 16, 17.

9. H.R. REP. NO. 704, 73d Cong., 2d Sess. (1934), *reprinted in* 1939-1 C.B. (pt. 2) 554, 564.

10. Pub. L. No. 98, § 202(c)(1), 42 Stat. 227, 230 (1923). In nonstatutory form, the principles of § 1031 appeared in regulations under the Revenue Act of 1918, specifically, Reg. 65, arts. 1563, 1565, and 1566, *cited in* 3 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 20.21 n.15 (rev. ed. 1981), and Reg. 45, art. 1563, T.D. 2971, 2 C.B. 38 (1920). *See also* 4 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS app. C (1981) (historical development of the nonrecognition concept).

11. Section 202(c)(1) expressly excluded "stock in trade" held primarily for sale from qualification as "property held for investment or productive use in trade or business."

12. *Id.* Section 202(c) actually provided for the nonrecognition of gain or loss on an exchange of any type of property unless the property received in the exchange had "a readily realizable market value." If the property had a recognized market value, then only the exchange of business or investment property (excluding stock in trade and other property held primarily for sale) for property of a like-kind or use qualified for nonrecognition. Section 203(a) of the Revenue Act of 1924 eliminated the "readily realizable market value" requirement, but carried forward its nonrecognition treatment of like-kind exchanges. Pub. L. No. 176, § 203, 43 Stat. 253, 256 (1924).

13. S. REP. NO. 275, 67th Cong., 1st Sess. (1921), *reprinted in* 1939-1 C.B. (pt. 2) 181, 188.

courts have derived the purpose of section 1031.¹⁴ The 1934 history reflects several reasons for retaining the like-kind exchange provision, including valuation difficulties and protection of revenues.¹⁵ Courts, however, generally have emphasized that the taxpayer in a like-kind exchange has continued his investment in the same kind of property and thus has realized only a theoretical profit or loss that in equity should qualify for nonrecognition treatment.¹⁶ This continuity of investment rationale now provides the basis for allowing nonrecognition treatment to like-kind exchanges under section 1031.¹⁷

In its present form section 1031 requires deferral of any gain or loss realized upon the exchange of property held for productive use in trade or business or for investment for property of a like kind.¹⁸ A taxpayer must satisfy three criteria to qualify for nonrecognition treatment based on a like-kind exchange. First, the taxpayer must exchange property for other qualified property.¹⁹ Second, the exchange must involve like-kind properties.²⁰ Finally, the taxpayer must have held the exchanged property for productive use in trade or business or for investment.²¹

14. [P]rofit or loss is recognized in the case of exchanges of notes or securities, which are essentially like money; or in the case of stock in trade; or in case the taxpayer exchanges the property comprising his original investment for a different kind of property; but if the taxpayer's money is still tied up in the same kind of property as that in which it was originally invested, he is not allowed to compute and deduct his theoretical loss on the exchange, nor is he charged with a tax upon his theoretical profit.

H.R. REP. NO. 704, 73d Cong., 2d Sess. 13 (1934), *reprinted in* 1939-1 C.B. (pt. 2) 554, 564.

15. The congressional record reflects a concern that the necessity of evaluating the property in "thousands of horse trades and similar barter transactions" would involve great administrative costs. The record shows that Congress believed that the net revenues that could be collected from the like-kind exchange transactions would not justify these additional administrative expenses. H.R. REP. NO. 704, 73d Cong., 2d Sess. 13 (1934), *reprinted in* 1939-1 C.B. (pt. 2) 554, 564.

16. *See* *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; *Duhl, Like-Kind Exchanges Under Section 1031: Multiparty Exchanges, Nonsimultaneous Exchanges and Exchanges of Partnership Interests*, 58 TAXES 949, 950-51 (1980); *Comment, The Exchange Requirement in Multiparty and Nonsimultaneous Exchanges: A Critical Analysis and Statutory Solution*, 37 Sw. L.J. 645, 645-48 (1983).

17. *Treas. Reg. § 1.1002-1(c)*, T.D. 6,500, 25 Fed. Reg. 11,954 (1960); *see, e.g., Leslie Co. v. Commissioner*, 539 F.2d 943 (3d Cir. 1976); *Jordan Marsh Co. v. Commissioner*, 269 F.2d 453 (2d Cir. 1959); *Wagensen v. Commissioner*, 74 T.C. 653 (1980); *Biggs v. Commissioner*, 69 T.C. 905 (1978), *aff'd*, 632 F.2d 1171 (5th Cir. 1980).

18. I.R.C. § 1031(a) (1982).

19. Qualifying property does not include "stock in trade or other property held primarily for sale . . . stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest . . ." I.R.C. § 1031(a) (1982); *see* *Madden, Taxation of Real Estate Transactions—An Overview*, 480 TAX. MGMT. (BNA) 98, 99-101 (1984).

20. As used in § 1031(a) the words "like kind" mean alike in "nature" and "character" and not necessarily alike in "grade or quality." Exchange of one kind of class of property for property of a different class may not occur under that section. *Treas. Reg. § 1.1031(a)-1(b)*, T.D. 6935, 1967-2 C.B. 292; *see* D. WALTERS, *REAL ESTATE EXCHANGES* 47-53 (1982); *Levine, Exchanging Interests in Partnerships Under Code Section 1031*, 17 TAX NOTES 649 (1982).

21. I.R.C. § 1031(a) (1982).

The third requirement, that the taxpayer have held exchanged property for investment, has evoked significantly fewer judicial and administrative interpretations than the exchange and like-kind requirements of section 1031.²² Neither the Code nor the regulations define the phrase "held for productive use in trade or business or for investment." Consequently, courts frequently have referred to sections 1221(1) and 1231 for guidance in interpreting section 1031 based on similar language in those sections.²³ Courts have interpreted the phrase "property held primarily for sale," used in the exclusionary parenthetical of section 1031(a), more liberally than the phrase "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business," which appears in sections 1221(1) and 1231.²⁴

A present intention of the taxpayer to sell the property received in an exchange precludes the exchange from receiving nonrecognition treatment under section 1031.²⁵ In particular, a dealer²⁶ must recognize his gain or loss on an exchange of property since he ordinarily does not hold the property for the required purpose. The dealer holds the property primarily for sale rather than for investment.²⁷ In situations not involving dealers, how-

22. Guttenberg, *Continuity of Investment is Key to Using 1031 in Combination with a Corporate Transaction*, 60 J. TAX'N 280, 280 (1984); see 7 FED. TAXES (P-H) ¶¶ 31,666, 31,667, 31,670 (1985).

23. Sections 1221(1) and 1231 contain similar, but not identical, language to § 1031. Sections 1221(1) and 1231 disallow capital gains treatment for gains from the sale of property "held by the taxpayer primarily for sale to customers in the ordinary course of (his) trade or business." I.R.C. §§ 1221(1), 1231(2) (1954, as amended through 1977); see also Margolis v. Commissioner, 337 F.2d 1001 (9th Cir. 1964) (court disallowed nonrecognition of exchange on basis that acquired properties were held for sale in the ordinary course of business); Rev. Rul. 59-229, 1959-2 C.B. 180 (under I.R.C. § 1031 unharvested crops treated as property used in trade or business, not as inventory based on I.R.C. § 1231(b)(4)); Treas. Reg. § 1.1031(a)-1(b) (1967) ("unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale"); D. WALTERS, *supra* note 20, at 80; Levine & McCormick, *Taxfree Exchanges Under Section 1031*, 61-4th [Portfolio] TAX MGMT. (BNA) 3 (1982).

24. See, e.g., Griffin v. Commissioner, 49 T.C. 253, 260 (1967) (court disallowed nonrecognition treatment on like-kind exchange because nondealer taxpayer had contracted to sell the acquired property prior to the exchange); Black v. Commissioner, 35 T.C. 90, 96 (1960) (court rejected taxpayer's argument that property acquired in a like-kind exchange but held primarily for sale should come within § 1031 if the sale was not within the taxpayer's ordinary course of business).

25. Griffin v. Commissioner, 49 T.C. 253 (1967); Black v. Commissioner, 35 T.C. 90 (1960); see also Regals Realty Co. v. Commissioner, 43 B.T.A. 194, 208 (1940), *aff'd*, 127 F.2d 923 (2d Cir. 1942) (property acquired in like-kind exchange and then sold upon liquidation of acquiring corporation was disqualified for nonrecognition of income under § 1031 since corporate taxpayer did not "hold for investment").

26. Although not defined in § 1031, a "dealer" is normally considered one who holds real estate in the normal course of his business. Courts often use the term "dealer" as a convenient means of differentiating investors from persons who buy and sell property in the normal course of their business. A dealer, however, is entitled to nonrecognition treatment if he holds property for investment and not for sale to customers. 3B J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 22.138 (1980); see Margolis v. Commissioner, 337 F.2d 1001, 1003 (1964).

27. Treas. Reg. § 1.1031(a)-1 (1967). *But see* Loughborough Dev. Corp. v. Commissioner, 29 B.T.A. 95, 98-99 (1933) (property acquired by real estate developer in exchange deemed eligible for nonrecognition treatment under § 1031 since the court found that the property had not been accumulated for immediate sale).

ever, the Tax Court has interpreted the holding requirement in light of each individual set of facts. In doing so, the Tax Court has not limited the primarily-for-sale²⁸ prohibition to dealers.²⁹ In one case the Tax Court held that a single-family home acquired in a like-kind exchange was taxable since the taxpayer offered the property for sale and did sell it shortly after she finished painting it.³⁰

In determining whether property met the holding requirement by examining when the taxpayer disposed of it, courts faced the difficult task of deciding how long taxpayers must hold the property to qualify for nonrecognition treatment under section 1031.³¹ Due to the difficulties of framing the holding requirement in terms of a time period, the question of a taxpayer's intent at the time of the exchange became an important factor in determining qualification for nonrecognition.³² In this context the critical time became the time of the exchange.³³ Thus, if at the time of an exchange the taxpayer intends to use the property received for personal purposes or to make a gift of such property, then the exchange does not satisfy the holding requirement of section 1031.³⁴ A tax-free exchange followed immediately by a taxable disposition of the exchanged property indicates that the taxpayer did not intend the property to represent a continuation of his investment.³⁵ Nevertheless, in a post-exchange gift case, *Wagensen v. Commissioner*,³⁶ the Tax Court allowed nonrecognition treatment on an exchange even though the

28. The Tax Court cited *Malat v. Riddell*, 383 U.S. 569, 572 (1966), in which the Supreme Court defined "primarily" to mean "of first importance." *Bernard v. Commissioner*, 26 T.C.M. (CCH) 859, 863 (1967).

29. See *Harr v. MacLaughlen*, 15 F. Supp. 1004 (D. Pa. 1936) (properties acquired by a bank or other institution solely for the purpose of foreclosure sale treated like dealer-held property); Rev. Rul. 75-292, 1975-2 C.B. 333 (property received in a like-kind exchange is not considered held for productive use in a trade or business or for investment if the taxpayer intends immediately to sell the acquired property).

30. *Black v. Commissioner*, 35 T.C. 90, 96 (1960).

31. Courts have not given a definitive term to the length of time taxpayers should hold the property for § 1031 purposes. Indeed, in describing the holding requirement, the text of the 64th *Congressional Record* indicated that after the exchange of like-kind property, the taxpayer "[t]hen . . . must hold the land he receives in exchange as an investment, at least, for a time". 64 CONG. REC. 2856 (1923) (statement of Rep. Hawley).

32. See, e.g., *Starker v. United States*, 602 F.2d 1341, 1354 (9th Cir. 1979) (court upheld nonrecognition treatment based on analysis of several decisions that emphasized the taxpayer's intention); *Smith v. Commissioner*, 537 F.2d 972, 976 (8th Cir. 1976) ("to determine whether a transaction is a sale or exchange, a court may look to the intent of the parties as well as to what was actually done"); *Alderson v. Commissioner*, 317 F.2d 790, 794 (9th Cir. 1964) (upholding § 1031 exchange on basis that taxpayer had no intention to sell his property for cash if it could be exchanged for other property of like kind); *Coastal Terminals, Inc. v. United States*, 320 F.2d 333, 337-38 (4th Cir. 1963) ("[w]hether the transaction constitutes a sale or an exchange for income tax purposes depends on the intent of the parties" (quoting *Sarkes Tazian, Inc. v. United States*, 240 F.2d 467, 470 (7th Cir. 1957))); *Biggs v. Commissioner*, 69 T.C. 905, 913-15 (1978) (parties' intent examined in analysis of qualification of exchange for nonrecognition treatment), *aff'd*, 632 F.2d 1171 (5th Cir. 1980); *Woodbury v. Commissioner*, 49 T.C. 180, 199 (1967) (upholding § 1031 exchange based on taxpayer's consistent intent and form).

33. Rev. Rul. 57-244, 1957-1 C.B. 247 (time of exchange crucial in evaluating validity of nonrecognition claim in multi-party exchange).

34. See *Click v. Commissioner*, 78 T.C. 225, 234 (1982).

35. *Regals Realty Co. v. Commissioner*, 43 B.T.A. 194, 208-09 (1940).

36. 74 T.C. 653 (1980).

taxpayer gave the investment property to his children as a gift nine months after the exchange.³⁷ In *Wagensen* the Tax Court found that the taxpayer's immediate intent to hold the acquired ranch for investment purposes satisfied the requirements of section 1031 despite the taxpayer's desire eventually to give the ranch to his children.³⁸ A later case with similar facts, however, produced a different holding.³⁹ These conflicting results provide evidence that courts may render fact-specific decisions regarding the holding requirement.

Some courts do not find the taxpayer's intent dispositive of qualification for section 1031 treatment.⁴⁰ These courts have held that in matters of taxation the substance of the actual transaction carries more weight than the taxpayer's declared purpose.⁴¹ Specifically, courts have stressed form over intent in cases involving three-cornered exchanges.⁴² Even though the taxpayer in a three-corner exchange acquires property with the intention of exchanging it again for a new parcel, the courts have upheld the applicability of section 1031 nonrecognition treatment based on the form of the transaction.⁴³

The holding requirement under section 1031 for post-exchange, nontax-

37. *Id.* at 660.

38. *Id.* at 659.

39. In *Click v. Commissioner*, 78 T.C. 225 (1982), seven months after the exchange of a farm for two residential properties, the taxpayer gave the residential properties to her two children and their families occupying the homes. The children selected the properties and paid insurance on them from the inception. The court held that the taxpayer never held the residential properties for investment purposes. *Id.* at 234.

40. In Ltr. Rul. 8429039 the IRS determined that a two-year holding period sufficiently met the holding period test of § 1031 even though the taxpayer intended to sell the property at the end of the two years. In an earlier ruling for the same taxpayer, Ltr. Rul. 8310016, the IRS had ruled that the taxpayer's intention to dispose of the property upon completion of the exchange would disqualify the exchange for nonrecognition treatment. *Section 1031 Applied to Property Held Two Years*, 61 J. TAX'N 224 (1984).

41. *Rogers v. Commissioner*, 44 T.C. 126, 136, *aff'd per curiam*, 377 F.2d 534, 535 (9th Cir. 1967) ("matters of taxation must be determined in the light of what was actually done rather than according to the declared purposes of the participants"); *J.H. Baird Publishing Co. v. Commissioner*, 39 T.C. 608, 615 (1962), *acq.* 1963-2 C.B. 4 ("parties' expectations or hopes as to the tax treatment of their conduct in themselves not determinative"); see also 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*, 17 WM. & MARY L. REV. 599, 603-04 (1976) (parties' intent with respect to transaction does not control if form of exchange found deficient).

42. A three-cornered exchange may occur when a taxpayer wishes to exchange his property to avoid the discontinuation of his investment and the recognition of his gain, but "the potential buyer of the taxpayer's property owns no property that the taxpayer wants to receive in exchange." *Biggs v. Commissioner*, 69 T.C. 905, 913 (1978). In order to effect a like-kind exchange, the buyer acquires from a third party property that meets the taxpayer's needs and then exchanges the acquired property for the taxpayer's property. *Id.*; see also Rev. Rul. 73-476, 1973-2 C.B. 300, 301 (gain or loss on § 1031 exchange not recognized); Rev. Rul. 57-244, 1957-1 C.B. 247, 248 (gain in § 1031 exchange recognized only to extent cash received).

43. In *Carlton v. United States*, 385 F.2d 238, 243 (5th Cir. 1967), taxpayers intended from the inception to exchange their property. Their 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. *Id.* See *Boise Cascade Corp. v. Commissioner*, 33 T.C.M. (CCH) 1443, 1448 (1974) (emphasizing form, the court looked to whether deeds were actually exchanged).

able distributions has received little attention in the courts. The Service, however, addressed this issue in a number of Revenue Rulings. In Revenue Ruling 75-292⁴⁴ the Service ruled that a taxpayer's transfer of property *A* to a third party in exchange for property *B*, followed immediately by the taxpayer's contribution of property *B* to his controlled corporation, does not qualify for nonrecognition treatment under section 1031.⁴⁵ The Service based its ruling on a finding that the property, once contributed to the corporation, does not qualify under the holding requirement.⁴⁶ According to the Service the taxpayer intended to contribute property *B* to the corporation.⁴⁷ When, however, a taxpayer made a section 1031 exchange followed by another section 1031 transaction, the Service took a contrary position. In Revenue Ruling 57-244⁴⁸ the Service ruled that a unilateral exchange of three parcels of real property among three parties qualified for tax-free treatment under section 1031. *A* transferred a parcel of property to *B*, *B* transferred a parcel to *C*, and *C* transferred a parcel to *A*. The Service held that the exchange qualified for nonrecognition under section 1031 for each of the participants.⁴⁹ By its ruling the Service indirectly ratified the proposition that holding the exchanged property for a subsequent exchange satisfies the holding requirement of section 1031.

Until the Tax Court's decision in *Magneson v. Commissioner*⁵⁰ and *Bolker v. Commissioner*,⁵¹ courts had not addressed the holding requirement issue as applied to a like-kind exchange that was followed or preceded by another tax-free transaction. In both cases the Tax Court chose to construe the holding requirement liberally, to overrule the Service's ruling, and to expand the scope of section 1031 exchanges. On appeal the Court of Appeals for the Ninth Circuit faced an issue of first impression.

II. *MAGNESON V. COMMISSIONER*

In *Magneson v. Commissioner* the Magnesons claimed that sections 1031 and 721 allowed nonrecognition treatment of a gain or loss from an exchange of like-kind properties and a subsequent contribution of the property to a partnership. In a unanimous opinion upholding the Magnesons' claim, the court initially addressed whether the exchange satisfied the holding requirement of section 1031(a).⁵² The Commissioner maintained that the tax-

44. 1975-2 C.B. 333, 334.

45. *Id.* The second leg of the transaction, contribution of the exchanged property, would fall within § 351, which allows a taxpayer to make a tax-free exchange of property for stock. I.R.C. § 351 (1982).

46. 1975-2 C.B. at 334.

47. *Id.*

48. 1957-1 C.B. 247; see also Rev. Rul. 73-476, 1973-2 C.B. 300, 301 (upholding validity of nonrecognition treatment for three-way exchange under § 1031).

49. 1954-1 C.B. at 248.

50. 81 T.C. 767, 771 (1983).

51. 81 T.C. 782 (1983), *aff'd*, 760 F.2d 1039 (9th Cir. 1985). The Ninth Circuit affirmed the *Bolker* decision based on the continuity of ownership analysis adopted by the Tax Court in *Magneson*. 760 F.2d at 1045. See Guttenberg, *supra* note 22, at 280-82.

52. 753 F.2d at 1492.

payers should not receive nonrecognition treatment because they did not hold the acquired Plaza Property for investment, as required by section 1031(a), after receiving it in exchange for the Iowa Street Property.⁵³ The Magnesons, however, asserted that they met the holding-for-investment requirement by holding the property for contribution to a partnership.⁵⁴ The majority in the Tax Court had found for the Magnesons based on its determination that the taxpayers continued their investment in the Plaza Property by contributing it to the U.S. Trust partnership.⁵⁵ The Tax Court emphasized form over substance in finding that the Magnesons satisfied the holding requirement because they did not liquidate their investment.⁵⁶ The Ninth Circuit reviewed the Tax Court's conclusions of law de novo.⁵⁷

To analyze whether the exchange in question met the section 1031(a) holding provision, the court examined that section's requirements as developed in case law. According to precedent an individual must, at the time he purchases the property, intend to keep that property for investment purposes to gain nonrecognition treatment.⁵⁸ Since the parties had stipulated that the Magnesons exchanged the property to hold it for contribution to the partnership,⁵⁹ the court found that the controlling question was whether the taxpayers satisfied section 1031, which requires that the taxpayer hold exchanged property for investment, by contributing the acquired property to a partnership in exchange for a partnership interest.⁶⁰

The court next addressed the Commissioner's reliance on Revenue Ruling 75-292,⁶¹ in which the Service had ruled that a transaction in which a taxpayer acquired property in a like-kind exchange and immediately transferred it to a controlled corporation did not satisfy the section 1031(a) holding requirement.⁶² The case presented in the ruling involved transfers to a corporation for stock,⁶³ which the court found distinguishable on several grounds

53. *Id.*

54. *Id.* at 1493.

55. 81 T.C. at 771-72.

56. *Id.*

57. The court cited *California Fed. Life Ins. Co. v. Commissioner*, 680 F.2d 85, 87 (9th Cir. 1982), in which the court held federal circuit courts had authority to review Tax Court decisions de novo. 753 F.2d at 1493.

58. 753 F.2d at 1493. The court cited *Regals Realty Co. v. Commissioner*, 127 F.2d 931, 934 (2d Cir. 1942), which disallowed tax-deferred treatment on an exchange because immediate disposition of the acquired property showed that the taxpayer did not have the requisite intent to hold the property for investment. Further, the court noted that in *Margolis v. Commissioner*, 337 F.2d 1001, 1005 (9th Cir. 1964), the Ninth Circuit allowed nonrecognition treatment on the part of the taxpayer's exchanged property because he satisfactorily proved that he did not intend to purchase the real estate for its income-producing potential. 753 F.2d at 1493.

59. 753 F.2d at 1493.

60. *Id.* The court noted a lack of precedent at both the Tax Court and the circuit court level. *Id.*

61. 1975-2 C.B. 333.

62. 753 F.2d at 1493. The court, however, noted that based on the holding of *Ricards v. United States*, 683 F.2d 1219, 1224 & n.12 (9th Cir. 1981), revenue rulings did not bind it, although such rulings deserve considerable respect for the expertise they carry. 753 F.2d at 1493.

63. 1975-2 C.B. at 333-34.

from a transfer to a partnership for a general partnership interest.⁶⁴ First the transfer of property to a corporation differs because a corporation forms an entity that is distinct from its shareholders.⁶⁵ A partnership, on the other hand, forms an association of its partner investors.⁶⁶ Second, the court reasoned that a taxpayer who transfers property to a corporation in exchange for stock relinquishes ownership and control of the property, but general partners maintain control of any property in the partnership.⁶⁷ Third, the court noted that the express language of section 1031(a) excludes stock as property eligible for exchange.⁶⁸ Based on these observations the court rejected the applicability of Revenue Ruling 75-292 to this case.⁶⁹

Having found the Commissioner's arguments unpersuasive, the court referred to the legislative history of section 1031 for guidance. The drafters of sections 1031(a) and 721⁷⁰ intended to provide for nonrecognition of gain on transfers of property in which the taxpayer receives property that differs only in form, and not in substance, from the property with which the taxpayer parted.⁷¹ The court stated that the taxpayers' transaction met this determinative test for nonrecognition under section 1031.⁷²

In prior cases under section 1031(a) courts examined the nature of the taxpayer's ownership interest as well as the type of property owned to decide whether the exchange met the requirements of that section.⁷³ Accordingly,

64. 753 F.2d at 1493.

65. *Id.*

66. *Id.*

67. *Id.* See generally CAL. CORP. CODE § 300 (West 1977) (management and control of corporation); *Id.* §§ 15,018(e), 15,024 (partner rights to management and control of partnership assets).

68. 753 F.2d at 1493-94.

69. *Id.* at 1494.

70. I.R.C. § 721 (1982); see *supra* note 4.

71. 753 F.2d at 1494 (citing Treas. Reg. § 1.1002-1(c) (1960)). Treasury Regulation § 1.1002-1(c) addresses the exceptions to the general rule that a taxpayer must realize his income or loss upon sale or exchange of property. I.R.C. § 1001 (1982). The regulation states that "[t]he underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated . . ." Treas. Reg. § 1.1002-1(c) (1960). The court stated that the continuation of the taxpayer's investment provides the basis for nonrecognition of gain or loss in the transactions that fall within §§ 1031 and 721. The taxpayer, in other words, remains in essentially the same economic situation after the transaction since he transferred his investment to like-kind property instead of liquidating it. 753 F.2d at 1494; see *Starker v. United States*, 602 F.2d 1341, 1352 (9th Cir. 1979); *Biggs v. Commissioner*, 69 T.C. 905, 913-14 (1978), *aff'd*, 632 F.2d 1171 (5th Cir. 1980); *Koch v. Commissioner*, 71 T.C. 54, 63-64 (1978).

72. 753 F.2d at 1494. The Commissioner and the dissenting judges in the Tax Court argued that the change in the form of ownership meant that the property did not meet the holding requirements of § 1031(a). *Id.* at 1495. Judge Tannenwald, writing for the dissent, disagreed with the majority's holding that the Magnesons' contribution to the partnership satisfied the requirements of § 1031 as the old investment continuing in an unliquidated, albeit modified, form. 81 T.C. at 775. He found the differences between the interest of a tenant in common and that of a general partner too great under California law to qualify as like-kind within the meaning of § 1031. *Id.* at 778.

73. See *Estate of Meyer v. Commissioner*, 503 F.2d 556, 557-58 (9th Cir. 1974) (*per curiam*) (general partnership and limited partnership interests not like-kind property); *Pappas v. Commissioner*, 78 T.C. 1078, 1086-87 (1982) (general partnership exchanged for general partnership qualifies as like-kind); *Long v. Commissioner*, 77 T.C. 1045, 1066-68 (1981) (joint venture exchanged for general partnership qualifies as like-kind); *Gulfstream Land & Dev.*

the court addressed the change in the nature of the Magnesons' ownership interest under California law.⁷⁴ The court concluded that a change in the form of legal ownership did not undermine the continuity of investment purpose under section 1031.⁷⁵ Both as tenants in common and as general partners the Magnesons had a right to possess and control the property.⁷⁶ Although California partnership law limits a partner's possession and control of partnership property,⁷⁷ the court found that the underlying purpose of the partnership, similar to the Magnesons' purpose as tenants in common, consisted of holding the Plaza Property for investment.⁷⁸ The court did not find the difference in the ability to alienate the property⁷⁹ under the common tenancy and the partnership interests persuasive because the underlying premise of section 1031 is to prevent alienation of property.⁸⁰

Having determined that the exchange met the continuity of investment principles of section 1031, the court considered the Commissioner's contention that focusing on the continuity of investment principle ignored the specific-description requirement of section 1031.⁸¹ Treasury Regulations under that section state that the Code provides nonrecognition treatment only when the exchange meets the Code's specific description of an exchange and the statute's underlying purpose.⁸² The court had rejected a similar argument in *Starker v. Commissioner*⁸³ because of the weight of authority against

Corp. v. Commissioner, 71 T.C. 587, 595 (1979) (joint venture exchanged for joint venture qualifies as like-kind); Koch v. Commissioner, 71 T.C. 54, 63-64 (1978) (unencumbered fee exchanged for fee subject to 99-year leasehold interest qualifies as like-kind).

74. In the application of federal tax statutes, state law controls in determining the nature of the legal interest that the taxpayer holds in the property asserted as taxable. Aquilino v. United States, 363 U.S. 509, 512-13 (1960).

75. 753 F.2d at 1497.

76. See Dimmick v. Dimmick, 58 Cal. 2d 417, 422, 374 P.2d 824, 826, 24 Cal. Rptr. 856, 858 (1962) (defining rights of tenants in common); CAL. CORP. CODE § 15025(1) (West Supp. 1984) (defining relationship among partners in general partnerships).

77. CAL. CORP. CODE § 15025(2)(a), (c), (d) & (e) (West Supp. 1984).

78. 753 F.2d at 1496. Compare the Tax Court's holding, which generalized under a broader continuity of investment analysis and looked at the economic basis and accounting of the property, which remained the same. 81 T.C. 767, 771 (1983).

79. The court noted that a tenant in common can freely alienate his interest, but a partner cannot freely alienate specific partnership property. 753 F.2d at 1496. Compare R. CUNNINGHAM, W. STOEBUCK & D. WHITMAN, THE LAW OF PROPERTY 198-99 (1984) (tenants in common are generally free to alienate property without co-tenant's permission) with R. HAMILTON, CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED PARTNERSHIPS 88-89 (1981) (citing UNIFORM PARTNERSHIP ACT § 25 (1969) (partner cannot separately assign his interest in partnership assets)).

80. 753 F.2d at 1496.

81. *Id.* at 1498. The Commissioner argued that an exchange must comply with that part of regulation 1.1002-1(b) that provides:

The exceptions from the general rule requiring the recognition of all gains and losses . . . are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Internal Revenue Code of 1954 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 an exchange is excepted from the general rule.

Treas. Reg. § 1.1002-1(b) (1960).

82. Treas. Reg. § 1.1002-1(b) (1960).

83. 602 F.2d 1341 (9th Cir. 1979).

such analysis.⁸⁴ The court emphasized that in a situation such as the Magnesons' transaction, in which the taxpayer continues to hold the property for investment, a variation in the form of ownership would not decide the issue of qualification for nonrecognition treatment if the taxpayer's control of his investment and the nature of the investment remained substantially the same.⁸⁵

The Commissioner alternatively argued that the step transaction doctrine prevented section 1031 nonrecognition.⁸⁶ This doctrine allows the court to collapse a taxpayer's several steps when the steps result in more favorable tax treatment than if the transaction had occurred in the direct route contemplated by the Code.⁸⁷ The court examined two other ways that the taxpayers could have achieved the same result, but concluded that neither hypothetical route more directly achieved the same end.⁸⁸ Based on cited precedent,⁸⁹ the court found that the taxpayers were entitled to accomplish their transaction by whichever of two equally direct modes would allow them the best tax treatment.⁹⁰

Despite its conclusion that the taxpayers chose the most direct route under the Code, the court stated that the Magnesons would have qualified for nonrecognition treatment even under the step transaction doctrine.⁹¹ The Commissioner argued that *Estate of Meyer v. Commissioner*⁹² precluded this result.⁹³ In *Meyer* a general partnership interest and a limited partnership interest did not qualify as like-kind property even though the underlying assets of the partnerships consisted of like-kind property.⁹⁴ The court distinguished *Meyer*, however, on the ground that *Meyer* involved general

84. *Id.* at 1352. The court found the following cases that liberally construed the § 1031 requirements more persuasive than the Commissioner's narrow construction in *Starker*: *Alderson v. Commissioner*, 317 F.2d 790, 793 (9th Cir. 1963) (nonrecognition treatment given to three-corner exchange); *Biggs v. Commissioner*, 69 T.C. 905, 913-14 (1978) (nonrecognition treatment given to four-corner exchange).

85. 753 F.2d at 1497.

86. *Id.*

87. See *Crenshaw v. United States*, 450 F.2d 472, 475 (5th Cir. 1971), *cert. denied*, 408 U.S. 923 (1972); *Commissioner v. Court Holding Co.*, 324 U.S. 331, 333 (1945).

88. 753 F.2d at 1497. The first alternative way that the Magnesons could have achieved the same result from their transaction involved selling the Iowa Street Property, buying ten percent of the Plaza Property with the proceeds, and then forming the partnership with N.E.R. Plaza, Ltd. By the second route the taxpayers could have "formed the partnership with the Iowa Street Property and ninety percent of the Plaza Property and then the partnership could have exchanged the Iowa Street Property for the remaining ten percent of the Plaza Property." *Id.*

89. The court cited *Biggs v. Commissioner*, 69 T.C. 905, 913 (1978), *aff'd*, 632 F.2d 1171 (5th Cir. 1980) (qualified in *Starker*, 602 F.2d at 1353 n.10).

90. 753 F.2d at 1497.

91. *Id.*

92. 503 F.2d 556 (9th Cir. 1974).

93. 753 F.2d at 1498. Focusing on the underlying purpose of the transaction and the management and control of the property, the court did not address the fact that the transaction, if collapsed, would have consisted of an exchange of the Iowa Street Property, which is real property, for a partnership interest, which is personalty under California law. Thus, collapsing the transaction under the doctrine in this theoretical manner would have disqualified the exchange under the like-kind requirement of § 1031. See CAL. CORP. CODE § 15026 (West 1977 & Supp. 1985).

94. 503 F.2d at 557-58.

partners and limited partners, whose rights with respect to partnership property differ more significantly than the general partners and fee owners in *Magneson*.⁹⁵

Finally, the court considered whether partnership interests qualified for exchange treatment under section 1031.⁹⁶ Following precedent,⁹⁷ the court held that an exchange of like-kind partnership interests could qualify for nonrecognition under section 1031 only if the underlying assets of the partnership also qualified as like-kind as defined by the section.⁹⁸ This requirement deters the formation and exchange of partnership interests composed of non-like-kind assets to circumvent the like-kind requirement of section 1031.⁹⁹ Applying this requirement to the case, the court found that the taxpayers' original investment corresponded in like-kind to property held by the partnership, and thus qualified for nonrecognition under section 1031(a).¹⁰⁰

Although the court affirmed the Tax Court decision for the Magnesons, the court limited its holding to those situations in which the taxpayer exchanges property for like-kind property with the intent of contributing the acquired property to a partnership for a general partnership interest.¹⁰¹ The court further narrowed its holding by requiring the taxpayer to show that the partnership exists to hold the property for investment and that the total assets of the partnership remain predominantly of like-kind to the taxpayer's original investment.¹⁰²

III. CONCLUSION

The section 1031 requirement that a taxpayer effecting a like-kind exchange must hold the acquired property for investment purposes has generated a variety of interpretations of the parameters of the holding requirement in case law, revenue rulings, and commentaries. In an attempt to define the holding requirement the courts and the Service have referred to other Code sections with similar language, examined the taxpayer's intent at the time of the exchange, considered the amount of time the taxpayer held the property, and reviewed the form of the transaction. These efforts, however, did not clearly define the holding requirement. The Service has persisted in its efforts to interpret the holding requirement narrowly. The decision in *Magneson v. Commissioner* introduces a much broader interpretation of the holding requirement. The decisions of both the Tax Court and the Ninth Circuit permit a taxpayer to satisfy the holding requirement, even though the taxpayer immediately disposes of the property, as long as the transaction satisfies the continuity of investment principle. Although this holding allows

95. 753 F.2d at 1497.

96. *Id.* at 1498.

97. The court relied on *Pappas v. Commissioner*, 78 T.C. 1078, 1087 (1982), and *Gulfstream Land & Dev. Corp. v. Commissioner*, 71 T.C. 587, 594-96 (1979).

98. 753 F.2d at 1498.

99. *See supra* note 97.

100. 753 F.2d at 1498.

101. *Id.*

102. *Id.*

the taxpayer to enter into another transaction immediately following a like-kind exchange, the continuity of investment principle limits the second transaction to a tax-free exchange or contribution that substantially continues the investment, though in modified form. *Magneson's* analytical approach to the holding requirement thus broadens the scope of section 1031 exchanges despite the court's limiting language.

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