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Proposal to Reform the Like Kind and Involuntary Conversion Rules in Light of Fundamental Tax Policies: A Simpler, More Rational and More Unified Approach

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I. INTRODUCTION

Almost from the beginning of the federal income tax, the law has contained two nonrecognition provisions¹ that have undergone relatively little change: the like kind rule and the involuntary conversion rule.² The like kind rule provides

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1. On the sale or other disposition of property, a taxpayer will realize gain or loss in an amount equal to the difference between the amount realized on the transaction and the taxpayer's adjusted basis in the disposed of property. I.R.C. § 1001(a) (2001). The gain or loss realized upon a disposition will not, however, be includable in gross income or deductible from income, respectively, to the extent that a nonrecognition provision applies to the disposition. *See id.* § 1001(c). All section references are to the Internal Revenue Code of 1986 as amended or the Treasury Regulations promulgated thereunder.

2. Both provisions were added in the Revenue Act of 1921. The Like Kind Rule-Revenue Act, Pub. L. No. 67-98, ch. 136, § 202 (c)(1), 42 Stat. 227, 230 (1921) (codified as amended at I.R.C. § 1031 (2000)); Involuntary Conversion Rule-Revenue Act, Pub. L. No. 67-98, ch. 136, §§ 214(a)(12), 234(a)(14), 42 Stat. 227, 241, 257 (1921) (codified as amended at I.R.C. § 1033 (2000)). The like kind rule remained substantially unchanged until 1984, when amendments were made to address deferred exchanges and

that no gain or loss is recognized if property held for productive use in the taxpayer's trade or business or for investment is exchanged for property of a like kind that is also held for productive use in a trade or business or for investment.³ This provision does not apply to exchanges of inventory property and other property held primarily for sale, nor does it apply to financial assets such as stocks, bonds, partnership interests, and the like.⁴ A taxpayer is required to recognize realized gain under the rule to the extent that she received money and non-like kind property in the exchange.⁵

The involuntary conversion rule permits elective nonrecognition of gain where property is condemned (or sold pursuant to a threat of condemnation), destroyed, or stolen and the taxpayer uses the conversion proceeds to purchase "property similar or related in service or use" (or a controlling stock interest in a corporation owning such property) generally within two years of the involuntary conversion.⁶ For certain condemnations of real property, like kind

exchanges of partnership interests. *See generally* Marjorie E. Kornhauser, *Section 1031: We Don't Need Another Hero*, 60 S. CAL. L. REV. 397 (1987). In 1989 and 1997, changes to the like kind rule were also made that deny like kind treatment for exchanges of U.S. and foreign property, as well as for certain exchanges between related parties. Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, § 7601, 103 Stat. 2301, 2370-71 (1989); Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1052, 111 Stat. 788, 940 (1997). The involuntary conversion rule first appeared as a deduction provision (with a carryover basis provision), but was changed to a nonrecognition rule in 1924. *See* Revenue Act, Pub. L. No. 68-176, ch. 234, § 203(b)(5), 43 Stat. 253, 256 (1924). The rule originally employed a requirement that conversion proceeds be traced to the investment in the replacement property. In 1951, Congress replaced the tracing requirement with a provision requiring that the replacement property be purchased within generally one year of the conversion. Internal Revenue Code Amendments, Pub. L. No. 82-251, 65 Stat. 733, 733-36 (1951). The general replacement period was extended to two years in 1969. Tax Reform Act of 1969, Pub. L. No. 91-172, § 915(a), 83 Stat. 487, 723 (1969). Other significant amendments to the involuntary conversion rule include the following: the addition in 1958 of Section 1033(g), which allows a taxpayer to replace condemned business or investment real property with like kind property, Internal Revenue Code Amendments, Pub. L. No. 85-866, § 46(a), 72 Stat. 1606, 1641 (1958); the addition in 1995 of Section 1033(i), which denies nonrecognition treatment for certain situations where replacement property is acquired from related parties, Internal Revenue Code Amendments, Pub. L. No. 104-7, § 3(a)(1), 109 Stat. 93, 94 (1995); and the addition in 1996 of Section 1033(b)(3), which requires certain reductions in the basis of a corporation's assets where the replacement property is stock in a corporation, Internal Revenue Code Amendments, Pub. L. No. 104-188, § 1610(a), 110 Stat. 1755, 1844-45 (1996).

3. I.R.C. § 1031(a)(1) (2000).

4. *Id.* § 1031(a)(2).

5. *Id.* § 1031(b).

6. *Id.* § 1033(a)(2).

replacement property is treated as satisfying the similar property standard.⁷ A taxpayer is required to recognize realized gain under the provision to the extent that the proceeds from the involuntary conversion exceed the cost of the similar replacement property.⁸ Both the like kind and involuntary conversion provisions are accompanied by special basis rules that preserve in the replacement property any realized gain (or loss in the case of the like kind rule) that went unrecognized on the transactions.⁹

Commentators have questioned the policy grounds for the like kind rule in general,¹⁰ and for some of its particular features, such as the exchange requirement.¹¹ Congress and its staffers have also noted the complexity caused by certain aspects of the rule and have enacted or proposed remedial changes in this regard.¹² The involuntary conversion rule also contributes to the complexity of the tax system given the fact-intensive analysis that it requires.¹³ Perhaps more fundamentally, the two nonrecognition rules generally use different standards for determining eligible replacement property, an apparent inconsistency that occasionally catches the attention of both Congress¹⁴ and commentators.¹⁵

7. *Id.* § 1033(g).

8. *Id.* § 1033(a)(2).

9. *Id.* §§ 1031(d), 1033(b).

10. See generally Kornhauser, *supra* note 2; Erik M. Jensen, *The Uneasy Justification for Special Treatment of Like Kind Exchanges*, 4 AM. J. TAX POL'Y 193 (1985).

11. See generally Steven J. Willis, *Of [Im]permissible Illogic & Section 1031*, 34 U. FLA. L. REV. 72 (1981).

12. See H.R. REP. NO. 98-432, pt. 2, at 1232-1233 (1984) (noting the administrative problems created by like kind treatment of non-simultaneous exchanges under pre-1984 law); S. PRT. 98-169, Vol. I at 242-43 (1984) (noting the administrative problems created by like kind treatment of non-simultaneous exchanges under pre-1984 law); STAFF OF THE JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM & RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, Vol. II at 300-05 (Comm. Print 2001) (pointing out complexities caused by the exchange and holding requirements).

13. See MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES 642 (4th ed. 2001) (noting the uncertainty that results under the involuntary conversion rule's similar property standard).

14. See S. REP. NO. 85-1983, at 4793-94, *reprinted in* 1958-3 C.B. 993-994 (seeing no reason why substantially similar rules should not be used for determining eligible replacement property for voluntary dispositions and condemnations of business or investment real property).

15. See Earle E. Endelman, Comment, *Involuntary Conversions Under Section 1033: An Appraisal*, 10 WAYNE L. REV. 588, 594 (1964) (arguing against a stricter standard under Section 1033 as compared to Section 1031).

This Article seeks to improve the like kind and involuntary conversion rules, that is, make the provisions more rational and less complex, by analyzing them in light of the fundamental tax policies of efficiency, equity, and administrability. A review of these rules under efficiency and equity principles arguably will lead to a more rational scheme for providing nonrecognition treatment to voluntary and involuntary dispositions given the recognized importance of these policies in structuring the federal income tax system. Further, a careful consideration of tax administration concerns should serve to simplify the application of these nonrecognition provisions.

Part II of this Article reviews the fundamental tax policies of efficiency, equity, and administrability. Part III examines the policies underlying the like kind and involuntary conversion rules and identifies the fundamental policies that may support these provisions. Part IV develops a methodology for reforming the like kind and involuntary conversion rules in light of fundamental tax policies that, in part, recognizes the limits of efficiency and equity analyses and the importance of administrability concerns. Part V then applies this methodology for reform to several features of the like kind and involuntary conversion rules, and recommends an approach that is generally simpler, more rational, and more unified. Part VI summarizes and concludes this Article.

II. FUNDAMENTAL TAX POLICIES

Tax theorists often base their analyses on a trio of fundamental policy concerns: efficiency, equity, and tax administration.¹⁶ While these scholars may use other policies as well, this Article's analysis of the like kind and involuntary conversion rules is based solely on these three fundamental tax policy concerns. Before analyzing the policies underlying the nonrecognition rules for like kind exchanges and involuntary conversions, it may be useful to review briefly these fundamental tax policies.

A. Efficiency

Tax efficiency is concerned with minimizing tax-induced changes in taxpayer behavior or decisions, or what are referred to as "substitution effects."¹⁷

16. See, e.g., GRAETZ & SCHENK, *supra* note 13, at 25-29; David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111, 1114-18 (1986); S. REP. No. 99-313, at 3-8 (1986).

17. See Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Under the Federal Income Tax*, 48 TAX L. REV. 1, 4 (1992). This efficiency norm is aimed at minimizing excess burden. See *id.* at 4. There is a different efficiency norm, one that is not used in this Article, for Pegouvian taxes that are designed to adjust for factors that prevent the market from functioning perfectly, such as externalities,

By being neutral at important decisional points, the tax system can minimize tax-induced changes in behavior.¹⁸ In applying an efficiency analysis to the realization rule, and related features such as nonrecognition provisions and the capital gains rate, tax theorists have identified two important decisional moments: (i) the time that a taxpayer decides to acquire an asset ("Time One"), and (ii) the time the taxpayer decides to dispose of an asset ("Time Two").¹⁹ At Time One, the differences in effective tax rates caused by the realization rule (among other features of the tax system) probably cause taxpayers to invest in certain assets over others. For example, because yield assets that produce currently taxed income do not benefit from the deferred taxation under the realization rule to the same extent as growth assets, the tax system encourages

inadequate economic growth, and underemployment of resources. See Charles R. Hulten & Robert A. Klayman, *Investment Incentives in Theory & Practice*, in *UNEASY COMPROMISE: PROBLEMS OF A HYBRID INCOME-CONSUMPTION TAX* 317, 328-30 (Henry J. Aaron et al. eds., 1988); Eric M. Zolt, *The Uneasy Case for Uniform Taxation*, 16 VA. TAX REV. 39, 69-72 (1996) (stating that market imperfections may justify departures from uniform taxation). Similar to determining optimal income tax rates, designing Pegouvian taxes that are aimed at overcoming market imperfections would require vast amounts of information about the economy, and, thus, there would appear to be a strong practical case against employing such taxes. Cf. Hulten & Klayman, *supra*, at 318 (stating that it would be virtually impossible to obtain the information necessary to determine optimal tax rates); RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, *PUBLIC FINANCE IN THEORY & PRACTICE* 293 (5th ed. 1989) (pointing out that despite optimal taxation theory, because of a lack of needed economic information, there is a practical case in favor of neutral taxation based on the view that more harm than good might be done by misguided differentiation). Consequently, I limit the efficiency analysis in this Article to that of minimizing excess burden.

Reducing administrative and compliance costs can be viewed as another objective of tax efficiency, as these costs along with tax-induced behavioral changes contribute to excess burden. Shaviro, *supra*, at 4. Nevertheless, this Article addresses administrative and compliance aspects separately from behavioral aspects, classifying the former as administrative concerns and only the latter as efficiency concerns; this is consistent with other analyses (see *supra* note 16) and appears appropriate given the possibly greater degree of certainty in evaluating administrative costs as compared to costs resulting from tax-induced behavioral changes. Cf. Mark P. Gergen, *The Logic of Deterrence: Corporate Tax Shelters*, 55 TAX L. REV. 255, 274-75 (2002) (stating that the most easily measured social costs of tax shelters are the tax planning costs associated with such strategies, as compared to the difficulty of measuring the magnitude of the social costs that result from the revenue loss due to tax shelters, including the allocative effects of taxpayers' responses to lower effective tax rates).

18. Shaviro, *supra* note 17, at 4.

19. See Shaviro, *supra* note 17, at 25. I acknowledge Professor Shaviro for both pointing out these important decisional moments and labeling them so succinctly.

overinvestment in growth assets.²⁰ Consequently, theorists use tax efficiency as a policy basis for accrual²¹ and retrospective taxation²² schemes, which generally would tend to bring about more equal tax rates on capital income.²³ At Time Two, the realization rule also affects the behavior of taxpayers by inducing them to refrain from changing investments because of the lower (or possibly zero) effective tax rates for longer holding periods (the so-called lock-in effect). Thus, even though a taxpayer holding an asset may want to diversify her risk, or believes other investments will yield higher returns, she may refrain from selling the asset in order to benefit from further tax deferral, thereby experiencing a tax-induced portfolio reallocation.²⁴ Proponents of accrual and retrospective taxation also refer to these Time Two efficiency costs of the realization rule in support of their proposals.²⁵ Features such as the capital gains rate and nonrecognition provisions result in both Time Two efficiency benefits and Time One efficiency costs; that is, by lowering (or deferring) the tax upon dispositions, these features both reduce the lock-in effect as well as increase the tax incentive for investing in certain assets benefitting from the realization requirement. For features such as these, it is necessary to employ an efficiency analysis that attempts to evaluate the net efficiency benefit or cost resulting from the provision under scrutiny.²⁶

B. Equity

Tax equity is usually broken down into two equity norms: horizontal equity and vertical equity.²⁷ Horizontal equity requires that similarly situated taxpayers

20. Fred B. Brown, "Complete" Accrual Taxation, 33 SAN DIEGO L. REV. 1559, 1571-72 (1996).

21. Accrual taxation includes in the tax base annual increases and decreases in the value of property, regardless of a disposition. *Id.* at 1560.

22. Retrospective taxation awaits a disposition to impose tax, but attempts to approximate accrual taxation by generally imposing an interest charge for the period between the accrual of the gains and the disposition of the property. *See* Mary Louise Fellows, *A Comprehensive Attack on Tax Deferral*, 88 MICH. L. REV. 722, 792-97 (1990).

23. *See* Brown, *supra* note 20, at 1568-73; Fellows, *supra* note 22, at 727.

24. *See* Brown, *supra* note 20, at 1569-70.

25. *See* Brown, *supra* note 20, at 1569-70; Fellows, *supra* note 22, at 727.

26. *See* Shaviro, *supra* note 17, at 25; George R. Zodrow, *Economic Analyses of Capital Gains Taxation: Realizations, Revenues, Efficiency, and Equity*, 48 TAXL. REV. 419, 469 (1993).

27. *See, e.g.,* Boris I. Bittker, *Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities?*, in *THE ECONOMICS OF TAXATION* 19 (Henry J. Aaron & Michael J. Boskin eds., 1980).

be taxed in a similar manner.²⁸ Tax theorists traditionally use horizontal equity to support measures aimed at having persons with equal economic income bear an equal tax burden, although the process of tax arbitrage can make the case against tax preferences somewhat less certain.²⁹ Vertical equity requires that differently situated taxpayers be treated in an appropriately different manner. Vertical equity is often used to justify the progressive rate structure, under which taxpayers with greater amounts of economic income are generally taxed more heavily than those with lesser amounts.³⁰ Tax theorists also use vertical equity principles to denounce tax benefits that are more widely available to higher income taxpayers.³¹

Over the last decade, a debate has ensued over whether horizontal equity has any significance independent of vertical equity.³² Professor Kaplow argues that horizontal equity is not an independent norm and that it is merely derivative of vertical equity: subjecting equals to the same tax burden automatically follows from imposing different tax burdens on unequals.³³ That is, if based on one's concept of vertical equity, individuals with incomes of \$200,000 or more are taxed at a forty percent rate, and those with incomes of less than \$200,000

28. *See id.*

29. *See id.* at 22-27; Brown, *supra* note 20, at 1574-76. Tax arbitrage is the process in which investors tend to be drawn to a tax-favored investment, thus, in theory reducing the investment's pre-tax rate of return until the after-tax rate of return is equal to that of equally risky investments. With the tax preference completely capitalized into the cost of the investment, the purchaser of a tax-favored asset would appear to receive only normal after-tax returns. Consequently, in this case horizontal equity is apparently not violated—despite a lower direct tax liability, the investor is also subject to an indirect tax as a result of the reduced pre-tax returns. Complete arbitrage probably does not occur, however; that is, investors will probably not be drawn to a tax-favored investment to the degree necessary to completely capitalize the cost of the tax preference. Consequently, behavioral adjustments to tax preferences probably only mitigate, rather than eliminate, horizontal equity. In addition, certain preferences, such as the differing effective tax rates resulting from the realization requirement, will vary based on the individual circumstances of a particular investor. For preferences of this type, even with complete arbitrage, horizontal equity will be eliminated only where the effective tax rate applying to the investor is the same rate that is implicit in the market capitalization, which is not a likely occurrence. *See* Brown, *supra* note 20, at 1574-76.

30. *See* GRAETZ & SCHENK, *supra* note 13, at 25.

31. *See* Reed Shuldiner, *A General Approach to the Taxation of Financial Instruments*, 71 TEX. L. REV. 243, 261-62 (1992) (referring to the benefit of deferral under the realization rule).

32. *See, e.g.,* Paul R. McDaniel & James R. Repetti, *Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange*, 1 FLA. TAX REV. 607 (1993).

33. *See* Louis Kaplow, *Horizontal Equity: Measures in Search of a Principle*, 42 NAT'L TAX. J. 139 (1989).

are taxed at a twenty percent rate, it necessarily follows that individuals with the same amount of income are taxed at the same rate. As Professors Cunningham and Schenk point out, equally taxing individuals with the same income does not mean that vertical equity is satisfied; a tax system that reversed the rate structure described above would satisfy horizontal equity but would likely violate most conceptions of vertical equity.³⁴ Moreover, as stated by Professors McDaniel and Repetti, vertical equity is also not an independent norm, but instead rests on one's theory of distributive justice.³⁵ Consequently, both horizontal equity and vertical equity are corollaries of some theory of distributive justice that supports a certain distribution of the tax burden. Nonetheless, horizontal equity can still serve an important function in determining whether the tax system advances distributive justice; specifically, where equals are not treated in an equal fashion, vertical equity and, by implication, distributive justice, is violated. Thus, horizontal equity can provide a convenient measure for evaluating whether the tax system is at odds with the normative principles underlying equity.

C. *Administrability*

Administrability is concerned with reducing the complexity of the tax system. Among the sources of complexity in the tax law are the intricacy of certain statutory and regulatory provisions, the ambiguity presented by provisions with more than one possible meaning, and the uncertainty created by vague provisions where additional official guidance is lacking.³⁶ Complexity causes burdens for taxpayers in their attempts to comply with law;³⁷ it also results in more tax planning by taxpayers along with its attendant costs.³⁸ With greater complexity, taxpayer noncompliance would appear likely to increase;³⁹ taxpayers may find it too difficult or too troublesome to fully comply, may take advantage of "gray areas" that result from complexity, or simply may not comply

34. See Nohel B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX. L. REV. 319, 363 (1993).

35. See McDaniel & Repetti, *supra* note 32, at 611.

36. Cf. STAFF OF THE JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM & RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, VOL. I at 5 (Comm. Print 2001) (noting that a source of complexity is a lack of clarity and readability of the law, which can result from overly technical or overly vague statutory language, as well as too much or too little guidance on certain issues).

37. See *id.* at 6.

38. See *id.* at 42.

39. See *id.* at 6 (noting it is widely reported that complexity reduces the levels of voluntary compliance; pointing out, however, that it is not possible to measure the effects of complexity on the levels of voluntary compliance).

because of a loss of respect for the tax system. Complexity also burdens the IRS and Treasury, given that the government is called upon to issue more guidance in the form of regulations and rulings,⁴⁰ as well as expend more effort in dealing with taxpayer noncompliance, whether actual or alleged. Complexity adversely affects the courts as well, by creating more instances where the judiciary needs to resolve taxpayer-government disputes over intricate, ambiguous, or uncertain tax rules.⁴¹ It stands to reason that duplicative tax rules—different rules that deal with similar situations—add to complexity by creating more instances where there is potential for intricacy, ambiguity, and uncertainty.⁴²

While continually a concern for tax scholars and policymakers, simplification may once again be at the top of Congress' tax reform agenda with the recent release of a simplification study prepared by the staff of the Joint Committee on Taxation, recommending several hundred changes to the Code in order to simplify the tax system.⁴³ Included among the recommendations are proposals aimed at eliminating duplicative tax rules.⁴⁴

D. Balancing Competing Policy Objectives

The tax law often reflects a balance of competing policy objectives. In particular, administrative considerations may take precedence over the other fundamental tax policy concerns. For example, while efficiency and equity concerns appear to support the use of accrual taxation for asset appreciation and depreciation, the realization rule is generally used because of the administrative difficulties presented by accrual taxation (that is, valuation and taxpayer illiquidity).⁴⁵ Similarly, because of administrative concerns, the tax system does not tax the imputed income on owner-occupied housing, nor does it index the

40. *Cf. id.* at 6 (pointing out that complexity makes it more difficult for the IRS to explain the tax law through published guidance).

41. *Cf. id.* at 7 (noting as a factor in identifying provisions that add complexity the extent to which a rule results in disputes between taxpayers and the IRS).

42. *Cf. id.* at 7, 9 (noting as a factor in identifying provisions that add complexity the existence of multiple provisions with similar objectives; analyzing simplification recommendations from the perspective of whether the provision could be eliminated because it is duplicative).

43. *See generally id.*

44. *See* STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 12, at 253 (recommending one definition of family for purposes of the constructive stock ownership rules); STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 36, at 52 (recommending one definition of qualifying child for purposes of the earned income credit, the child credit, the dependency exemption, the dependent care credit, and head of household filing status).

45. *See* Brown, *supra* note 20, at 1560-61.

basis of assets for inflation, even though strong efficiency and equity arguments can be made for these measures.⁴⁶ While it seems that efficiency and equity may more often yield to administrability in deciding among major features of the tax system, the reverse occurs as well; for example, the system strives to tax net income, as opposed to gross income, a much simpler determinant, because of the undesirable efficiency and equity consequences that would result from a gross income tax.

III. FUNDAMENTAL TAX POLICIES UNDERLYING THE LIKE KIND AND INVOLUNTARY CONVERSION RULES

This Part examines the policies in support of nonrecognition treatment for like kind exchanges and involuntary conversions. The focus here is to determine what fundamental tax policies, if any, underlie these nonrecognition provisions.

A. Policies Supporting the Like Kind Rule

Nonrecognition treatment for like kind exchanges has been justified on continuity of investment grounds; that is, to the extent that a taxpayer continues an investment in similar property, she has not effectively realized a profit on the disposition, similar in effect to the taxpayer continuing to hold the original property.⁴⁷ Probably with less emphasis, the like kind provision has also been justified on administrative grounds because of valuation difficulties and taxpayer liquidity concerns.⁴⁸

The continuity of investment rationale by itself, however, is not what I would view as a fundamental tax policy basis; this rationale does not expressly relate either to efficiency, equity, or administrability. Yet, where a taxpayer has continued her investment despite a disposition, efficiency as well as horizontal equity may support nonrecognition treatment.

As demonstrated by Professor Shaviro, efficiency concerns provide a plausible justification for the like kind provision.⁴⁹ Where a taxpayer is viewed as continuing her investment, she ends with property that bears some similarity

46. See DEP'T OF TREASURY, BLUEPRINTS FOR BASIC TAX REFORM 86 (1977) (discussing the taxation of imputed income on owner-occupied housing). See generally Reed Shuldiner, *Indexing the Tax Code*, 48 TAX L. REV. 537 (1993) (analyzing indexation).

47. See, e.g., H.R. REP. NO. 98-432, pt. 2, at 1232 (1984); S. PRT. 98-169, Vol. I at 242 (1984); Jensen, *supra* note 10, at 199-207.

48. See, e.g., H.R. REP. NO. 98-432; S. PRT. 98-169, Vol. I at 242 (1984); Kornhauser, *supra* note 2, at 407.

49. See Shaviro, *supra* note 17, at 45.

to what she had originally, thus, resulting in a perceived lack of significant change in her position.⁵⁰ In the absence of nonrecognition treatment, the taxpayer may be deterred by the tax consequences from engaging in such transactions, given its relative lack of significance apart from tax consequences;⁵¹ in other words, such transactions are relatively tax-elastic. In contrast, transactions that significantly change a taxpayer's position, such as cash sales or non-like kind exchanges, are less tax-elastic; that is, taxing these transactions is less likely to deter them.⁵² Consequently, the like kind exchange rules may produce efficiency benefits at Time Two by providing nonrecognition treatment to transactions that are more tax elastic, thereby avoiding the deterrence of these transactions and reducing tax-induced changes in behavior.⁵³

Professor Shaviro also points out, however, that allowing nonrecognition treatment for like kind exchanges may also produce efficiency costs.⁵⁴ Allowing nonrecognition treatment for certain transactions at Time Two decreases the expected taxation at Time One on assets benefitting from the realization requirement, thereby providing a greater tax incentive to invest in these assets as opposed to assets whose income is taxed currently.⁵⁵ As noted earlier, the realization requirement results in varying effective tax rates on capital income, which in turn causes Time One distortions.⁵⁶ With the prospect of nonrecognition for like kind exchanges and other situations, taxpayers would have an even greater tax incentive to invest in certain assets benefitting from the realization requirement, thus, increasing the Time One distortions and efficiency costs. In addition, nonrecognition treatment for like kind exchanges may produce Time Two distortions: taxpayers who would otherwise engage in cash

50. See Shaviro, *supra* note 17, at 45.

51. See Shaviro, *supra* note 17, at 45. This appears to be part of the original rationale for the enactment of the like kind rule. See S. REP. NO. 67-275, *reprinted in* 1939-1 C.B. 189 (providing that the like kind rule, as well as a nonrecognition rule applying to certain corporate reorganizations and formations, permits "business to go forward with the readjustments required by existing conditions" by "eliminating many technical constructions which are economically unsound"). In enacting the like kind rule and other nonrecognition provisions in the Revenue Act of 1921, Congress may also have been motivated by a desire to provide tax benefits to the business community. See *infra* notes 70, 214.

52. See Shaviro, *supra* note 17, at 31-32.

53. See Shaviro, *supra* note 17, at 45.

54. See Shaviro, *supra* note 17, at 45.

55. See Shaviro, *supra* note 17, at 25-28, 45.

56. For example, because growth assets, such as land, receive a greater relative benefit from the realization rule's deferred taxation than yield assets, such as some financial instruments, overinvestment in growth assets is encouraged by the tax system. See Brown, *supra* note 20, at 1571-72.

sales or non-like kind exchanges would have a tax incentive for engaging in like kind exchanges.⁵⁷

Taken together, the efficiency case for the like kind rule is a balance of these benefits and costs. On the one hand, nonrecognition treatment for like kind exchanges produces efficiency benefits at Time Two by allowing relatively tax-elastic transactions not to be deterred by current taxation. On the other hand, the like kind rule results in efficiency costs by increasing the tax incentive at Time One for investing in assets benefitting from the realization requirement and the like kind provision, as well as by providing a tax incentive at Time Two for engaging in a like kind exchange as opposed to a cash sale or non-like kind exchange. It is unclear which way this balance tips given the enormous challenges involved in obtaining the needed empirical data on tax elasticities and welfare losses.⁵⁸ Nonetheless, while there is uncertainty, it is at least plausible that efficiency considerations support nonrecognition treatment for like kind exchanges.⁵⁹

On the other hand, upon first analysis, it would seem that horizontal equity provides no guidance on the propriety of the like kind exchange provision. After all, the usual basis for making horizontal equity comparisons is the ability to pay tax, and economic income is often viewed as the best measure of ability to pay;⁶⁰ with this comparative basis, it is unclear whether providing nonrecognition treatment to like kind transactions promotes equity. For example, assume that there are three taxpayers who each purchased an asset on January 1, 2001 for \$100. On December 31, 2001, each asset is worth \$200. On December 31, 2001, the first taxpayer sells her asset for \$200 in cash, the second taxpayer exchanges her asset for a like kind asset worth \$200, and the third taxpayer continues to hold her asset until the close of the year. All three taxpayers had \$100 of economic income during 2001, yet the third taxpayer will be able to defer the tax on the \$100 of income, while the first taxpayer will be liable for a current tax, thus, experiencing a higher effective tax rate on the income. Providing nonrecognition treatment to the like kind exchanger treats the exchanger like the continued holder, but creates horizontal inequity with the seller. Similarly, imposing current tax on the exchanger produces equity with the seller but not with the holder. Consequently, horizontal equity is violated

57. See Shaviro, *supra* note 17, at 25; Lawrence Trent, Comment, *Tax-Free Exchanges of Like Kind Investment or Business Property: A Proposal for Legislative Revision of Internal Revenue Code Section 1031*, 53 S. CAL. L. REV. 355, 371-72 (1979); Kornhauser, *supra* note 2, at 411.

58. See Shaviro, *supra* note 17, at 6, 25, 32, 66.

59. See Shaviro, *supra* note 17, at 6, 45, 66.

60. See, e.g., Cunningham & Schenk, *supra* note 34, at 364.

with economic income as the comparative basis, regardless of whether the second taxpayer receives nonrecognition treatment on the like kind exchange.⁶¹

Thus, given the failure of our realization based tax system to reach economic income as it accrues, traditional horizontal equity analysis provides no guidance on whether the system should contain the like kind rule. One possibility then would be to ignore completely horizontal equity considerations in evaluating the like kind rule. Alternatively, in situations such as this where assumed features of the tax system (here, the realization requirement) foreclose an equity analysis based on economic income, one could refer to another type of equity, that is, *perceptual* equity, for guidance. That is, in deciding on the propriety of the like kind rule, one might consider whether or not the provision is perceived as equitable.⁶² Before proceeding further, it is necessary to explain the reasons why it might be appropriate to consider perceptual equity. Looking to perceptual equity for guidance where traditional equity provides none would at least allow equity in some form to enter into the analysis regarding the propriety of the like kind rule. In this regard, perceptual equity arguably has value in that taxpayers' beliefs regarding fairness may significantly affect whether the tax system is fair.⁶³ As Jane Gravelle points out, "the perception of unfair treatment can alter welfare as well as the reality."⁶⁴

61. Cf. David A. Weisbach, *Should a Short Sale Against the Box Be a Realization Event?*, 50 NAT'L TAX J. 495, 497-98 (1997) (reaching a similar conclusion upon analyzing a short against the box tax proposal under horizontal equity, with economic income as the comparative base).

62. Other commentators similarly have noted the importance of perceptual equity. See, e.g., Cunningham & Schenk, *supra* note 34, at 368-69.

63. See James W. Wetzler, *The Role of Fairness in State Tax Policy*, 47 REC. ASS'N B. CITY N.Y. 38, 39 (1992) ("Fairness is a question largely of perception: a tax system is fair when taxpayers believe that their tax burdens are not out of line with their situations and to burdens imposed on other taxpayers."); Charles E. McLure, Jr., *Comments, in DO TAXES MATTER?* 332, 333 (Joel Slemrod ed., 1992) ("[P]erhaps the perception of fairness should be elevated to equal status with the traditional goals.").

64. Jane G. Gravelle, *Comments on M. Graetz and E. Sunley, Minimum Taxes and Comprehensive Tax Reform, in UNEASY COMPROMISE: PROBLEMS OF A HYBRID INCOME-CONSUMPTION TAX* 419, 423 (Henry J. Aaron et al. eds., 1988); see Edward J. McCaffery, *Capital Gains: What's the Point, and Are We Missing It?*, 43 TAX NOTES 223, 224 (1989) (stating that psychic value costs may make a capital gains rate cut undesirable). The use of perceptual equity in this context bears some similarity to the use of second-best efficiency analysis to evaluate features of the tax system such as the capital gains preference. Because of distortions caused by the realization requirement, in particular, the lock-in effect, an efficiency analysis of the capital gains preference focuses on reducing inefficiencies produced by the realization requirement, rather than on eliminating such inefficiencies entirely. See, e.g., Cunningham & Schenk, *supra* note 34, at 360-75. Arguably similar, the analysis here assumes the horizontal inequities

Moreover, perceptions of inequity may adversely affect compliance with the tax laws by undermining taxpayer morale, which is very important in a tax system based on self-assessment.⁶⁵

Applying horizontal equity in the perceptual sense, however, leads to no firm conclusions regarding the like kind rule. On the one hand, a taxpayer involved in a like kind exchange, despite the disposition, continues to hold property that is similar to the property exchanged, and, thus, may be perceived as similarly situated to a taxpayer who continues to hold the same property; consequently, because the continued holder would have no recognized gain, then neither should the like kind exchanger.⁶⁶ On the other hand, it can be contended that because of the disposition, a taxpayer involved in a like kind exchange should not be perceived as similarly situated to a taxpayer who continues to hold the same property, and that the closer comparison is to a taxpayer who voluntarily disposes of her property either for cash or non-like kind property in a taxable transaction, and, thus, the like kind exchanger should be treated the same.

Besides continuity of investment, the other purported justification for the like kind rule is tax administration. While possibly implicated, however, administrability is not a key rationale for the like kind rule. Although like kind exchanges may raise valuation issues, this would generally only be the case for two party like kind exchanges. It would appear that most like kind exchanges today are of the three cornered variety, and these transactions very typically involve a transfer of money equal to either the value of the relinquished property or that of the replacement property; consequently, for these exchanges, valuation is not an obstacle to current taxation, given that the parties will, in effect, be valuing the relinquished (or replacement) property at a specific dollar amount.⁶⁷

(based on economic income) created by the realization requirement, but attempts to evaluate whether provisions such as the like kind rule (as well as the involuntary conversion rule, which is analyzed below) reduce overall inequity by advancing perceptions of equity.

65. See, e.g., Charles E. McLure, Jr., *The Budget Process and Tax Simplification/Complication*, 45 TAX L. REV. 25, 57 (1989); Cunningham & Schenk, *supra* note 34, at 368; Michael J. Graetz & Emil M. Sunley, *Minimum Taxes & Comprehensive Tax Reform*, in UNEASY COMPROMISE: PROBLEMS OF A HYBRID INCOME-CONSUMPTION TAX 385, 405 (Henry J. Aaron et al. eds., 1988); Gravelle, *supra* note 64, at 423; Tracy A. Kaye, *Sheltering Social Policy in the Tax Code: The Low-Income Housing Credit*, 38 VILL. L. REV. 872, 917-22 (1993).

66. Cf. *Jordan Marsh Co. v. Commissioner*, 269 F.2d 453, 456 (2d Cir. 1959) (determining that in enacting the like kind rule, "Congress was primarily concerned with the inequity . . . of forcing a taxpayer to recognize a paper gain which was still tied up in a continuing investment of the same sort").

67. See Richard David Harroch, Comment, *Section 1031 Exchanges: Step Transaction Analysis and the Need for Legislative Amendment*, 24 UCLA L. REV. 351,

Even for two party like kind exchanges, valuation difficulties must not be a major justification for nonrecognition treatment; otherwise, all in kind exchanges, whether like kind or not, would be treated as nonrecognition events.⁶⁸ Similarly, taxpayer illiquidity, another possible administrative concern, is not a concern in commonly used deferred exchanges,⁶⁹ and in any event, would justify nonrecognition treatment for all in kind exchanges.⁷⁰

B. Policies Supporting the Involuntary Conversion Rule

Nonrecognition treatment for involuntary conversions is often justified on equitable grounds; that is, it would be unfair to require a taxpayer to recognize gain where there is forced realization followed by a re-investment in similar property.⁷¹ Missing from the usual justification is an elaboration as to why gain recognition would be inequitable under these circumstances.⁷² Arguably, horizontal equity notions provide a rationale for the involuntary conversion rule. As with like kind exchanges, horizontal equity would need to be applied not in the traditional sense, that is, with economic income as the basis for comparison, but in the perceptual sense.⁷³ Under this mode of analysis, it would appear that a strong case can be made for the involuntary conversion rule; that is, a taxpayer who disposes of property pursuant to an involuntary conversion and acquires

358-59 (1976).

68. See *Jordan Marsh Co.*, 269 F.2d at 456; Kornhauser, *supra* note 2, at 410; Trent, *supra* note 57, at 358-59.

69. As discussed *infra* Part V.B, a deferred exchange is effectively a cash sale followed by a re-investment of the proceeds.

70. Aside from the continuity of investment and administrative justification for the like kind rule, other considerations may have played a role in its enactment or continued existence. Chief among these other factors may have been a desire on the part of Congress to provide tax benefits to the business community, either for political reasons or in order to provide an economic stimulus. See Kornhauser, *supra* note 2, at 433-41; Trent, *supra* note 57, at 367. While either or both of these reasons may have been important, I do not view them as fundamental tax policy bases for enacting or retaining the like kind rule. Obviously, the desire to win the political support of certain taxpayers should not form the basis of fundamental tax policy. Furthermore, although an efficiency case (based on adjusting for market imperfections) may exist for providing economic stimulus, it would appear that the existing knowledge regarding economics is insufficient to support targeted tax subsidies intended to promote economic growth. See *supra* note 17.

71. See, e.g., MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION: A LAW STUDENT'S GUIDE TO THE LEADING CASES AND CONCEPTS 42, 334 (9th ed. 2002).

72. See, e.g., CHIRELSTEIN, *supra* note 71, at 42 (stating that it seems unfair to subject the taxpayer to current taxation in these circumstances).

73. See *supra* notes 60-66 and accompanying text.

similar property within a reasonable time period can be perceived as being similarly situated to a taxpayer who continues to hold the same property. Because the continued holder is not required to recognize gain, then apparently neither should the taxpayer involved in the involuntary conversion.⁷⁴ While the involuntary converter did dispose of property, this disposition was forced upon her and arguably should be ignored in the equity comparison, given that these circumstances suggest that the taxpayer did not intend for the disposition to occur.⁷⁵ In this regard, the perceptual horizontal equity basis for the involuntary conversion rule is more powerful than that for the like kind provision, given that the latter involves voluntary dispositions. That is, as

74. See Joseph M. Dodge, *Taxes and Torts*, 77 CORNELL L. REV. 143, 162-63 (1992) (viewing the involuntary conversion rule as justified by the policy of taxing similarly situated investors the same). Subjecting an involuntary converter to current taxation would result in a twofold burden for the taxpayer. First, in light of the time value of money, current taxation of asset appreciation results in a higher effective tax rate as compared to deferred taxation. See, e.g., Mark P. Gergen, *The Effects of Price Volatility and Strategic Trading Under Realization, Expected Return and Retrospective Taxation*, 49 TAX L. REV. 209, 231-36 (1994). Second, with current taxation, an involuntary converter that replaces the converted property may lack liquid funds to pay the tax; as a result, the taxpayer may be required to use some of the conversion proceeds to pay the current tax liability, thereby not replacing the converted property completely, and possibly altering her business or investment operations. The continued holder, who arguably should be perceived as similarly situated, faces neither of these burdens.

Professor Shaviro suggests that the liquidity problem could be addressed by allowing involuntary converters to pay their tax liabilities on a deferred basis, as opposed to granting nonrecognition treatment. See Shaviro, *supra* note 17, at 27. Such a measure, however, would not eliminate the disparity in effective tax rates experienced by involuntary converters and continued holders, and, therefore, would not be an appropriate response if one accepts the perceptual horizontal equity case for the involuntary conversion rule. Professor Shaviro is not evaluating the involuntary conversion rule under equity considerations (see Shaviro, *supra* note 17, at 3), and, thus, the problem that he identifies as well as his suggested solution relate only to efficiency and administrability analyses of the provision.

75. Cf. LAURIE L. MALMAN ET AL., PROBLEMS, CASES AND MATERIALS ON FEDERAL INCOME TAXATION 763 (1994) (stating that Section 1033 is premised on the hardship of imposing taxation where it is unlikely that the taxpayer intended to dispose of the property); GRAETZ & SCHENK, *supra* note 13, at 640 (stating that Congress considered it unfair to impose a tax where the taxpayer probably did not intend to dispose of the property and reinvests the conversion proceeds in replacement property); Lawrence A. Frolick, *Personal Injury Compensation as a Tax Preference*, 37 ME. L. REV. 1, 20 (1985) (stating that the involuntary conversion rule allows taxpayers to elect out of an unplanned disposition, thereby providing involuntary converters the same choice enjoyed by taxpayers that voluntarily dispose of property); Mark A. Cochran, *Should Personal Injury Damage Awards Be Taxed?*, 38 CASE W. RES. L. REV. 43, 46-47 (1987) (stressing the involuntary transaction aspect of Section 1033).

compared to a like kind exchanger, there is a considerably stronger claim that an involuntary converter who acquires similar property should be perceived as more closely situated to a continued holder of the same property, as opposed to a taxpayer who voluntarily disposes of property in return for cash or dissimilar property.

While perceptual horizontal equity may support the involuntary conversion rules, efficiency concerns apparently do not. As Professor Shaviro points out, because the conversions are involuntary, they would occur with or without nonrecognition treatment; thus, the Time Two efficiency benefits that result from the like kind rule, that is, avoiding the deterrence of tax-elastic transactions, are not produced by the involuntary conversion provision.⁷⁶ Consequently, only the efficiency costs of nonrecognition appear to be present: the Time One distortions that result from reducing the expected tax for assets benefitting from the realization requirement and the Time Two distortions that occur because of the tax incentive to use the conversion proceeds to acquire similar replacement property.⁷⁷

IV. A METHODOLOGY FOR REFORMING THE LIKE KIND AND INVOLUNTARY CONVERSION RULES IN LIGHT OF FUNDAMENTAL TAX POLICIES THAT RECOGNIZES THE LIMITATIONS OF EFFICIENCY AND EQUITY ANALYSES AND THE IMPORTANCE OF TAX ADMINISTRATION

As noted earlier, this Article aims to make the like kind and involuntary conversion rules more rational and less complex by analyzing them in light of fundamental tax policies. This Part addresses the methodology that will be employed in reforming these nonrecognition rules. Before doing so, it is important to explain the assumptions on which the following analysis is based.

The analysis in the previous Part suggests the like kind rule may be justified on efficiency grounds. The previous analysis also indicates that the involuntary conversion rule may be supported by perceptual horizontal equity principles,

76. See Shaviro, *supra* note 17, at 46.

77. See Shaviro, *supra* note 17, at 46. Professor Shaviro notes, however, that tax-free recoveries of insurance on personal assets under the involuntary conversion rule may produce efficiency benefits by decreasing the tax system's preexisting bias against purchasing such insurance. See *id.* at n.180. The efficiency and equity consequences of the involuntary conversion rule bear some similarity to the consequences of not using a head tax to raise revenue. Even though a head tax would be the most efficient form of taxation, undesirable equity consequences counsel against its use. Thus, in not using a head tax, a decision has been made to tolerate efficiency costs in order to promote equity, considerations that also appear to underlie the involuntary conversion rule.

but apparently not by efficiency concerns; thus, the involuntary conversion rule appears to be a product of competing policies, a phenomenon noted earlier.

The efficiency and horizontal equity bases for the like kind and involuntary conversion rules, respectively, are not (and probably never will be) certain. The efficiency case for the like kind rule faces daunting empirical challenges,⁷⁸ while the perceptual equity case for the involuntary conversion rule appears to be laden with value judgments. Nevertheless, decisions about these rules need to be made.⁷⁹ Consequently, in analyzing the provisions in light of fundamental tax policies, scholars and policymakers have no choice other than to make reasonable assumptions as to whether the policies of efficiency or equity support these nonrecognition rules. For the like kind rule, I assume for purposes of this Article the correctness of the efficiency argument; that is, providing nonrecognition treatment to voluntary transactions that result in a lack of significant change in position produces efficiency benefits at Time Two that outweigh the efficiency costs at Time One and Time Two. With regard to the involuntary conversion provision, I assume the validity of the perceptual horizontal equity rationale; that is, nonrecognition treatment should be accorded to a taxpayer who involuntarily disposes of property and acquires insignificantly different property within a reasonable time period because such a taxpayer is perceived as similarly situated to a taxpayer who continues to hold the same property.

Any revisions made to the like kind and involuntary conversion rules should be consistent with the fundamental tax policies that are assumed to underlie the provisions. Perhaps of greater significance, however, in reforming these nonrecognition rules are tax administration concerns. Although the rules are not grounded on administrative considerations, such concerns are always of importance in devising tax provisions. Moreover, in this context administrability should take on added significance, given that the efficiency and equity rationales for these nonrecognition rules suggest with limited specificity the features that the rules should contain. The efficiency case for the like kind rule depends in part on determining tax elasticities, measurements that are difficult, if not impossible, to make.⁸⁰ Similarly, the perceptual horizontal equity case for the involuntary conversion rule is based on judging whether the circumstances of a taxpayer involuntarily disposing of property and acquiring similar property are close enough to a taxpayer who continues to hold the same property, a decidedly imprecise inquiry. As a result, even with the assumption that these policies

78. See Shaviro, *supra* note 17, at 6, 25, 32, 66.

79. Cf. Shaviro, *supra* note 17, at 66 (pointing out the same about the realization and recognition rules despite the empirical obstacles that limit an efficiency analysis of these rules).

80. See Shaviro, *supra* note 17, at 32.

support the provisions, the efficiency and horizontal equity underpinnings of the rules provide no more than broad generalizations as to the types of transactions that warrant nonrecognition treatment—those transactions that result in a lack of significant change in position.⁸¹ Therefore, in crafting the particular features of the like kind and involuntary conversion rules, it may be uncertain as to which of several design options would better promote the underlying policies given the limitations of efficiency and equity analyses. Where this occurs, tax administration concerns should be the deciding factor in selecting the particular feature.⁸² With regard to certain features, however, it may be clear which design option better advances efficiency or equity. If that option is also the most administrable of the choices, the rules should employ it. If, on the other hand, another option would better promote administrability, a balance should be struck between efficiency (or equity) and simplification in deciding on the particular feature. The next Part of this Article employs this reform methodology in examining various features of the like kind and involuntary conversion rules.

V. EXAMINING THE FEATURES OF THE LIKE KIND AND INVOLUNTARY CONVERSION RULES

This Part will apply the methodology for reform developed in the previous Part to several features of the like kind and involuntary conversion rules. In order to focus and limit the analysis, features of the rules were chosen for examination based on both their relative importance and complexity. Relatively important features are those that relate to satisfying the basic requirements for nonrecognition treatment, such as the standard for determining eligible replacement property and the required linkage between the disposition of the relinquished property and acquisition of the replacement property. Complex features are those that involve uncertainty or intricacy. Based on this selection process, certain relatively important features will not be examined because they are not complex (for example, the type of property excluded from the coverage of the like kind rule),⁸³ and certain complex features will not be examined

81. See *infra* notes 89-93 and accompanying text.

82. Cf. Weisbach, *supra* note 61, at 503-04 (concluding that administrative considerations should dominate in crafting a rule treating short against the box and related transactions as realization events, given the uncertain efficiency gains of the proposal being evaluated).

83. See I.R.C. § 1031(a)(2) (2000). For the most part, determining whether property is excluded from Section 1031's coverage should be relatively straightforward, given that the exclusions generally are categories of assets whose parameters do not necessitate a fact-intensive analysis; that is, it is fairly easy to determine whether an asset is stock, a bond, or the like. The Section 1031(a)(2)(A) exclusion for stock in trade or other property held primarily for sale, however, does have the potential for generating

because they are not relatively important (for example, the related party rules under both provisions).⁸⁴ Specifically, this Part will apply the reform methodology to the following features of the like kind and involuntary conversion rules: (i) the standards used for determining eligible replacement property under both provisions, (ii) the exchange requirement under the like kind rule, (iii) the replacement periods under both rules, (iv) the holding requirement under the like kind rule, and (v) the controlling stock interest provision under the involuntary conversion rule.

Except with respect to the determination of eligible replacement property, it is not a primary goal of this Article to conform the nonrecognition rules for voluntary dispositions and involuntary conversions of property. Nevertheless, a by-product of the recommended reforms may be the general conformance of these nonrecognition rules which in turn may result in additional tax administration benefits. The last section of this Part explores these aspects.

A. The Standards for Determining Eligible Replacement Property

1. One Versus Two Standards

The like kind provision and the involuntary conversion rules use separate standards for determining eligible replacement property. For like kind exchanges, the replacement property must be of "like kind" to the relinquished

administrative burdens because of the fact-specific and possibly nebulous inquiry required by this exclusion. See Howard J. Levine, *Taxfree Exchanges Under Section 1031*, 567-3d TAX MGMT. A-29 (2001) (noting that with respect to certain taxpayers, it may be difficult to determine the motive for holding a particular piece of property). Nonetheless, similar exclusions for inventory and like property are contained in Sections 1221(a)(1) and 1231(b)(1) (although, as illustrated by *Black v. Commissioner*, 35 T.C. 90, 96 (1960), these exclusions would appear to require a higher threshold in light of their language providing that the property be held primarily for sale to customers in the ordinary course of a business); consequently, regardless of Section 1031 treatment, a similar inquiry would likely be required for purposes of determining capital gain versus ordinary income treatment either on the sale of similar property held by the taxpayer or the disposition of the relinquished property if the taxpayer receives boot in the transaction. Therefore, it would appear that the Section 1031(a)(2)(A) exclusion does not add appreciably to the complexity of the tax law. In any event, it would appear that efficiency concerns (along with the aforementioned administrability considerations) support excluding inventory and the like from Section 1031 nonrecognition treatment; because the amount of profits earned by sellers of inventory is greatly dependent on the frequency of sales, dispositions of inventory property do not appear to be relatively tax-elastic, and, thus, according like kind nonrecognition treatment to inventory dispositions would not appear to produce efficiency benefits at Time Two.

84. See I.R.C. §§ 1031(f), 1033(i) (2000).

property.⁸⁵ For involuntary conversions, the replacement property generally must be “similar or related in service or use” to the relinquished property,⁸⁶ with an exception for condemnations of business or investment real estate where like kind replacement property satisfies the similar property standard.⁸⁷ The two standards are quite different, with the like kind standard generally being the more liberal and objective of the two.⁸⁸ Given the similar function of these two standards, the issue arises as to whether the use of a single standard would better promote fundamental tax policies.

The efficiency and horizontal equity underpinnings of the like kind and involuntary conversion rules appear to provide as much support for a single standard to determine eligible replacement property as they do for two standards. As discussed previously, efficiency concerns are assumed to justify the like kind rules because of the efficiency benefits that result from granting nonrecognition treatment to relatively tax-elastic transactions.⁸⁹ Because there is limited knowledge regarding tax elasticities in this context,⁹⁰ however, the efficiency rationale for the like kind rule appears to call for no more precise a standard than one that allows nonrecognition treatment for voluntary transactions which result in a lack of significant change in the taxpayer’s position.⁹¹ While, based on reasonable assumptions, some types of replacements would clearly result in significant changes (e.g., land replacing a speculative intangible) and others would clearly not be significant (e.g., one piece of unimproved rural land for another piece of unimproved rural land), there are probably a range of transactions for which it cannot be determined with any confidence whether efficiency would be promoted if nonrecognition treatment were permitted.

As noted earlier, horizontal equity principles are assumed to support the involuntary conversion rule because of the perceived similarity between a taxpayer who continues to hold the same property and a taxpayer who is forced to dispose of property and ends up holding similar property.⁹² Here too,

85. *Id.* § 1031(a)(1).

86. *Id.* § 1033(a).

87. *Id.* § 1033(g).

88. *See infra* notes 110-31 and accompanying text.

89. *Supra* notes 49-59, 78-79 and accompanying text.

90. *See Shaviro, supra* note 17, at 32 (“[T]he tax elasticity of a transaction is an empirical attribute that cannot be judged in the abstract, is hard to measure in practice, and even if measured may change at any time.”).

91. *See Shaviro, supra* note 17, at 33-34 (pointing out that nontax significance matters in making a transaction less tax-elastic “because, the greater the range and importance of the nontax implications of a decision, the more likely the taxpayer is to have a strong preference, and the less likely the decision is to be in such close equipoise that tax considerations will tip the balance”).

92. *See supra* notes 71-77, 78-79 and accompanying text.

however, the policy rationale does not dictate a precise standard for determining eligible replacement property, given the imprecision involved in making equity comparisons; thus, all that can be said is that the perceptual horizontal equity basis for involuntary conversions supports nonrecognition treatment for those conversions and replacements that result in a lack of significant change in the taxpayer's position. The inexactitude of the equity determinations underlying the involuntary conversion rule is underscored by the fact that the rule effectively uses two different standards for involuntary conversions of real property—the like kind test for condemnations of business or investment real estate and the more narrow similar property standard for all other real property conversions.⁹³

Consequently, while different policy rationales underlie the two provisions, each of the policies is rather indefinite in prescribing a standard for eligible replacement property and appears to simply support a standard requiring that the replacement property not be significantly different from the relinquished property. As a result, it appears that these policies provide as much support for a single standard that defines insignificantly different property for purposes of determining eligible replacement property as they do for different standards.

In fact, additional horizontal equity considerations indicate that there may be even more support for using a single standard.⁹⁴ That is, the use of different standards for voluntary and involuntary dispositions of property may violate horizontal equity by generally imposing a stricter standard for achieving nonrecognition treatment on a taxpayer who involuntarily disposes of property, especially with regard to real property. For example, a taxpayer who suffers the destruction of improved real estate and uses the conversion proceeds to acquire unimproved real estate would have to recognize any realized gain on the disposition,⁹⁵ whereas a taxpayer who voluntarily exchanges improved real estate for unimproved real estate would not.⁹⁶ While the taxpayer involved in the involuntary conversion temporarily held cash, and the taxpayer involved in the like kind exchange did not, taxpayers involved in like kind exchanges can achieve the economic effect of a sale and reinvestment through the use of

93. See I.R.C. § 1033(g) (2000).

94. Again, horizontal equity would have to be used in the perceptual sense. See *supra* notes 60-66, 73-75 and accompanying text.

95. See Treas. Reg. § 1.1033(a)-2(c)(9)(i) (2001).

96. See *id.* § 1.1031(a)-1(c). This assumes the second taxpayer satisfies the holding requirement under the like kind rule. A stricter standard also applies to involuntary conversions of some personal property. For example, a barge and a tug do not satisfy the similar property standard under the involuntary conversion rule, but do generally meet the like kind standard. See *id.* §§ 1.1033(a)-2(c)(9)(iii), 1.1031(a)-2(b)(2)(xii), Rev. Proc. 87-56, 1987-2 C.B. 674, as modified and clarified by Rev. Proc. 88-22, 1988-1 C.B. 785.

deferred, three-cornered exchanges.⁹⁷ Consequently, it is arguable that the two taxpayers in the example should be perceived as similarly situated and that the use of a stricter standard for granting nonrecognition treatment to the involuntary converter violates horizontal equity by treating similarly situated taxpayers in a dissimilar manner.⁹⁸

Indeed, in a limited context, Congress seems to have recognized that the rationales for the like kind and involuntarily conversion rules do not demand different standards and that using the same standard for voluntary and involuntary dispositions is more equitable. As noted earlier, Section 1033(g), added in 1958, treats like kind property as satisfying the similar property standard on condemnations of business or investment real estate. In enacting this provision, Congress acknowledged that there is no reason why the same standard should not be used to determine what constitutes a continuity of investment for both voluntary exchanges and condemnations of business or investment real estate.⁹⁹ Congress also stated that it is particularly unfortunate that the law at that time had applied a more narrow standard to dispositions that were beyond the taxpayer's control,¹⁰⁰ thus, apparently recognizing the horizontal inequities that may arise from a dual approach for nonrecognition treatment.¹⁰¹ Nonetheless, Congress only adopted the use of a single standard in the context of voluntary exchanges and condemnations of business or investment real estate, despite the fact that its stated rationale for doing so suggests that the same standard be used for all involuntary conversions and voluntary dispositions.¹⁰²

97. See STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 12, at 301. Furthermore, as discussed *infra* Part V.B, this Article recommends that the like kind rule employ an express rollover mechanism, like that used for involuntary conversions.

98. See Endelman, *supra* note 15, at 594 (arguing that the same test that is applied to voluntary exchanges, also should be applied to involuntary conversions of all property (not just condemnations of business or investment real estate) in order to "achieve a more equitable distribution of nonrecognition of gain").

99. See S. REP. NO. 1983, 1958-2 C.B. 993.

100. See *id.*

101. See Endelman, *supra* note 15, at 594 (viewing Congress' enactment of Section 1033(g) as an acknowledgment of the inequity that results from applying a stricter standard for nonrecognition treatment to involuntary conversions as compared to voluntary exchanges).

102. Perhaps Congress felt that it was not important to equate the two standards outside of the context of condemnations of business or investment real estate, given that most involuntary conversions probably involve such situations. Cf. Bruce N. Edwards, *Involuntary Conversions*, 568-3d TAX MGMT. A-30 (noting that most Section 1033 applications involve condemnations of business or investment real property). There appears to be no reason for not applying a single standard to other types of conversions, however, even if they occur less frequently than real property conversions, and, as discussed below, administrative considerations favor the use of a single standard for all

As the preceding analysis indicates, efficiency and horizontal equity concerns do not appear to require different replacement property standards, and a single standard may even have more support. Furthermore, with tax administration concerns in mind, it is reasonably clear that a single standard is the better approach. The use of a single standard should result in less of an administrative burden on the IRS and Treasury, given that the government would have only one standard to apply and would also no longer need to issue administrative pronouncements for the deleted standard. With one standard, there might also be less of a burden for the courts, because there should be fewer legal issues to decide. Taxpayers (and their advisors) should also benefit from the elimination of one of the standards, as there would be less law of which to be knowledgeable, and the law on the single standard may be better thought out and less uncertain, given that government officials may have more time to devote to this single standard as opposed to dividing their efforts in administering two standards.

As noted earlier, the Joint Committee on Taxation, in its recently published simplification study, has similarly recognized the complexity added to the tax system by multiple rules with similar objectives.¹⁰³ In this regard, the Joint Committee has recommended several changes aimed at ridding the system of duplicative provisions, such as adopting a uniform definition of qualifying child for purposes of determining eligibility under the dependency exemption and the earned income credit, among other provisions,¹⁰⁴ as well as a uniform definition of family for purposes of applying the various attribution rules contained in the Code.¹⁰⁵ Clearly, a stronger case for simplification exists with respect to having a uniform definition of qualifying child as compared to using a single standard for determining eligible replacement property, given that the multiple definitions that exist under current law are a major source of taxpayer confusion and errors.¹⁰⁶ Yet, the simplification case for eliminating one of the two standards for determining eligible replacement property is more than just plausible, and similar to the case for adopting a uniform definition of family for attribution

property covered under Sections 1033 and 1031.

In 1989, Congress came close to adopting a single standard for all types of property covered under the like kind and involuntary conversion rules when the House passed a bill that would have applied the similar property standard to exchanges under Section 1031. H.R. 3299, 101st Cong. § 11601(a). This part of the House bill was dropped by the Conference Committee and, thus, was not enacted into law. H. R. REP. NO. 101-614 (1990).

103. See STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 36, at 7.

104. See STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 12, at 52.

105. See STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 12, at 153.

106. See STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 12, at 50-51.

purposes.¹⁰⁷ Consequently, while the use of a single standard would not be a major blow for simplification, it would at least be a step in the right direction.

2. The Appropriate Standard

The decision to use the same standard to determine eligible replacement property under both the like kind and involuntary conversion rules raises the issue of what standard to use. In this regard, several design options are available. First, a decision needs to be made as to the general approach used in determining eligible replacement property—the two main options being a categorization approach similar to that used under the like kind standard¹⁰⁸ or a facts and circumstances approach like that employed under the similar property standard.¹⁰⁹ Second, once a general approach is selected, the details of the approach must be prescribed: in particular, the specific asset groupings used under a categorization approach, or the factors considered and degree of similarity required under a facts and circumstances approach. This section proceeds by first deciding between the like kind standard or the similar property standard as the general approach to be used in light of fundamental tax policies, and then determines whether modifications to the selected approach are needed in order to further advance these policies.

a. Like Kind or Similar Property

From the standpoint of administrability, the like kind standard appears to provide the greater amount of certainty, and, thus, appears to be the simpler one for taxpayers, practitioners, and the IRS to apply. With regard to dispositions of real property, there is seldom an issue of whether the replacement property qualifies as like kind, given that almost all real property is treated as like kind.¹¹⁰ In addition, for dispositions of depreciable tangible personal property, most like kind determinations are relatively straightforward as a result of the like class approach employed in the Section 1031 regulations, under which depreciable

107. See STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 12, at 254 (pointing out that a uniform definition of family for attribution purposes would achieve some simplification in that taxpayers, practitioners, and the IRS would have a single definition to apply).

108. See *infra* notes 110-17 and accompanying text.

109. See *infra* notes 118-22 and accompanying text.

110. See Treas. Reg. § 1.1031(a)-1(b) (2001). As an exception, the statute provides that U.S. and foreign real property are not of like kind. I.R.C. § 1031(h)(1) (2000). In addition, the IRS has ruled that unimproved land and improvements made to land already owned by that taxpayer are not of like kind. See Rev. Rul. 71-41, 1971-1 C.B. 223.

tangible personal properties are treated as like kind if they are either within the same "General Asset Class" or "Product Class."¹¹¹ For this purpose, the regulations incorporate the asset and product classifications issued by the federal government for depreciation and industrial purposes, respectively.¹¹² Thus, for example, a personal computer and a printer are of like kind because they are in the same asset class,¹¹³ whereas an airplane and a heavy general purpose truck are not of like kind because they are in different asset classes.¹¹⁴ While a less definite approach is applied with respect to intangible personal property, even here the regulations use a somewhat structured approach that looks at both the rights involved (*e.g.*, copyright or patent) and the underlying property to which the intangible relates.¹¹⁵ For example, the regulations provide that a copyright on one novel is of like kind to a copyright on a different novel, whereas a copyright on a song is not of like kind to a copyright on a novel.¹¹⁶ Finally, the regulations employ an easy to apply approach for goodwill and going concern value, providing that the goodwill or going concern value of one business is never of like kind to that of another business.¹¹⁷

In contrast, the similar property standard that is generally used for involuntary conversions requires a fact-intensive and somewhat subjective analysis of the particular characteristics of the relinquished and replacement properties. Consequently, this test results in more uncertainty and, thus, greater administrative burdens for the government and taxpayers in terms of compliance, controversy, and predictability. To elaborate, where the taxpayer used (as opposed to leased) the converted property, the so-called "owner user" prong of the similar property test requires that the relinquished and replacement properties

111. See Treas Reg. § 1.1031(a)-2 (2001).

112. See *id.*

113. See *id.* § 1.1031(a)-2(b)(7).

114. *Id.* Technically, properties that are in different asset or product classes can still be treated as like kind property if they are otherwise considered to be of like kind; however, it appears very unlikely that this would occur, given that the test that would apply for this purpose would likely be similar to the rather narrow standard used under the involuntary conversion rule. Cf. Howard J. Levine, *New Personal Property and Multi-Asset Exchange Regs. May Increase Taxable Gain*, 73 J. TAX'N 16 (1990) (pointing out that prior to the issuance of the like class rules, it was thought that the like kind standard for depreciable tangible personal property was similar to the "similar in service or use" test used for involuntary conversions). Of course, if, as this Article subsequently recommends, the similar property test is eliminated, only the like class component of the standard for tangible personal property would remain.

115. See Treas. Reg. § 1.1031(a)-2(c)(1) (2001).

116. See *id.* § 1.1031(a)-2(c)(3).

117. *Id.* § 1.1031(a)-2(c)(2).

have closely similar physical characteristics and end uses,¹¹⁸ thus, necessitating a comparison of these attributes. Where the taxpayer leased the converted property to another, the “owner investor” prong of the standard compares, with respect to the relinquished and replacement properties, the taxpayer’s management activities, services rendered to the tenants, and business risks.¹¹⁹ Like any fact-intensive analysis, the risk of inconsistent outcomes is high. For example, according to the authorities, the owner-user test is satisfied where prune, apricot, and walnut orchards replace a truck and cattle farm,¹²⁰ but not where billiard facilities replace bowling facilities.¹²¹ While in both situations the relinquished and replacement properties were involved in the same general, but not specific, type of business (farming in the one and recreation in the other), the results under the similar property standard differ.¹²²

The promulgation of the personal property rules under the like kind regulations underscores the administrative advantages of the like kind standard as compared to the similar property standard. Before the adoption of these regulations, the like kind standard as applied to personal property was quite murky, with most of the guidance focusing on esoteric items rather than the more mundane types of personal property.¹²³ In many cases, taxpayers and the IRS were left to grapple with the amorphous general standards provided in the regulations.¹²⁴ The prior like kind standard regarding personal property closely resembled the similar property standard because of this general lack of guidance, as well as the limited guidance that suggested using a fact-intensive approach.¹²⁵

118. See, e.g., Rev. Rul. 76-319, 1976-2 C.B. 242.

119. See, e.g., Rev. Rul. 64-237, 1964-2 C.B. 319.

120. See *Stevenson v. United States*, 64-2 USTC ¶ 9821 (N.D. Cal. 1964).

121. See Rev. Rul. 76-319, 1976-2 C.B. 242.

122. The degree of uncertainty under the similar property standard versus the like kind standard may be further indicated by the number of cases and rulings addressing the application of these standards. RIA, *United States Tax Reporter, Income Tax*, lists twice as many cases and IRS rulings that involve applications of the similar property standard as compared to the like kind standard. Compare RESEARCH INSTITUTE OF AMERICA, 11 UNITED STATES TAX REPORTER, INCOME TAX, ¶ 10,335.22 with ¶ 10,315.02. Given that a voluntary disposition appears to be more common than an involuntary one, it would appear that the higher degree of uncertainty associated with the similar property standard is responsible for the apparently greater number of cases and rulings that address the application of the similar property standard.

123. See John A. Bogdanski, *On Beyond Real Estate: The New Like-Kind Exchange Regulations*, 48 TAX NOTES 903, 904-05 (1990).

124. See Treas. Reg. § 1.1031(a)-1(b) (2001) (“the words ‘like kind’ have reference to the nature or character of the property and not its grade or quality”).

125. Cf. Rev. Rul. 82-166, 1982-2 C.B. 190 (IRS ruling that gold bullion and silver bullion held for investment are not of like kind because they are “intrinsically different metals and primarily are used in different ways”).

In a move lauded by commentators as a blow for certainty, the Treasury promulgated regulations specifically dealing with the like kind status of personal property, which, as noted earlier, employ a relatively easy to apply asset classification approach for depreciable tangible personal property.¹²⁶ The decision to adopt the personal property regulations recognizes the administrative value of having a well-defined, categorization method for determining eligible replacement property as opposed to an amorphous, facts and circumstances approach.¹²⁷

In addition, the like kind standard may have administrative advantages over the similar property standard with regard to transactions involving multiple properties, for example, where the assets of one business are disposed of and the assets of another business serve as replacement property. The regulations employ a fragmented approach for evaluating replacement property under the like kind standard, under which the separate properties disposed of and acquired

126. See Bogdanski, *supra* note 123, at 907. Despite their administrative advantages, the like kind personal property regulations have been criticized on other policy grounds; that is, using depreciation and industrial classifications to determine like kind status may not be appropriate given the different purposes involved in establishing these classifications. *See id.* The property groupings for depreciation, industrial, and like kind purposes do share an important common feature, however, in that each of the groupings contains similar types of property. Moreover, the use of these similar property classifications for purposes of Section 1031 supports a view espoused by this Article—that the policy underlying the like kind rule calls for no more precise a standard than one requiring that the relinquished and replacement properties be not significantly different, and that the specifics of the standard should be determined based on tax administration concerns.

127. The like kind standard's administrative advantages over the similar property standard can also be likened to the administrative advantages of the current rules for determining depreciation periods as compared to prior law. Prior to the enactment of the asset depreciation system, a property's useful life for computing depreciation deductions was generally determined under a facts and circumstances approach that was quite uncertain and led to controversies between taxpayers and the IRS. *See* STAFF OF JOINT COMM. ON TAXATION, PROPOSED DEPRECIATION AND INVESTMENT TAX CREDIT REVISIONS, 3-12 (Comm. Print 1981), *reprinted in*, STANLEY S. SURREY ET AL., FEDERAL INCOME TAXATION: CASES AND MATERIALS 467 (Successor ed. 1986). With the enactment of the asset depreciation range system, Congress provided the IRS with the authority to publish class lives for various property types (*see* I.R.C. § 167(m) (2000)), thus promoting certainty and reducing the amount of controversy with regard to the determination of depreciation periods. *See id.* at 470. This approach was continued with the enactment of ACRS, which bases recovery periods on the class lives published pursuant to the asset depreciation range system. *See* I.R.C. § 168(c), (e) (2000). Similarly, the use of the like standard, as opposed to the similar property standard, promotes certainty and reduces controversy given its categorization approach for determining eligible replacement property.

in a multiple asset transaction are individually determined to be of like kind.¹²⁸ While the regulations use a very intricate approach in applying the like kind rule to multiple asset transactions,¹²⁹ they do provide definite rules that build on the objective like kind standards used for real property and most personal property, and, thus, appear to have the benefit of certainty. In contrast, it is somewhat unclear how the similar property standard applies to an involuntary conversion of multiple assets. While the IRS has indicated that an asset-by-asset approach should be used,¹³⁰ the courts have employed an aggregate approach in evaluating the conversion of an entire business under the similar property standard.¹³¹ Although it is possible to apply a fragmented approach in evaluating the conversion of a business, there would seem to be some inconsistency in using such an approach given that the owner-user test is partly concerned with the functions of the relinquished and replacement properties, which might be more appropriately determined by examining a business as a whole. An aggregate approach, however, may pose serious administrative difficulties due to the need to weigh in the overall evaluation the effect of some clear differences in the business' asset composition, and because of the high tax stakes involved in the inquiry: that is, the recognition of the entire amount of realized gain on the business properties if the similar property standard is determined not to be satisfied. Moreover, even if a fragmented approach were to be used under the similar property standard, there is a good deal of uncertainty regarding its exact application; unlike the detailed rules for multiple asset transactions under the like kind regulations, there are no rules that provide an exact methodology for dealing with multiple asset conversions. Consequently, the greater certainty provided by the use of a fragmented approach, and the definite rules for multiple

128. See Treas Reg. § 1.1031(j)-1 (2001).

129. Specifically, the regulations separate the relinquished and replacement properties that are determined to be of like kind into "exchange groups," with each grouping of like kind assets constituting a separate exchange group. The amount of recognized gain for each exchange group is then determined on an aggregate basis and is equal to the lesser of the realized gain on the transaction for that group or the "exchange group deficiency," which is essentially defined as the excess of the total fair market value of the properties relinquished in an exchange group over the total fair market value of the properties received in that exchange group. See Treas. Reg. § 1.1031(j)-1(b)(2)(iv) (2001). There are additional rules for dealing with situations where boot or liabilities are transferred or received in the transaction.

130. See Rev. Rul. 70-465, 1970-2 C.B. 162. The IRS has also, however, appeared to use an aggregate approach. See Rev. Rul. 76-319, 1972-2 C.B. 242 (billiards center with a bar and lounge ruled not similar in its entirety to bowling center with a bar and lounge).

131. See, e.g., *Massillon-Cleveland-Akron Sign Co. v. Commissioner*, 15 T.C. 79 (1950).

asset transactions, appear to be additional administrative reasons for preferring the like kind standard over the similar property test.

Regarding efficiency and equity, these policy concerns (that are assumed to support the provisions) do not appear to provide any real guidance on the details of the standard, other than calling for a standard that permits nonrecognition treatment for situations where a taxpayer experiences an insignificant change in position.¹³² With respect to personal property, either standard appears to satisfy this “insignificant change in position” touchstone. While the similar property standard may be more narrow because it generally requires a close similarity between the relinquished and replacement properties,¹³³ the asset groupings employed under the like kind standard do involve assets with a reasonable degree of similarity.¹³⁴ For real property dispositions, however, only the similar property standard may limit nonrecognition treatment to transactions resulting in an insignificant change in position, given that almost all real property is of like kind under the Section 1031 standard.¹³⁵

Despite the efficiency and equity issues raised by the broad like kind test for real property, this Article recommends that the like kind standard be used as the general approach for determining the eligibility of replacement property under both the like kind and involuntary conversion rules. For personal property, either standard appears to require the requisite quantum of resemblance between the relinquished and replacement properties; yet, the objective, categorization approach employed under the like kind standard has clear administrative advantages over the amorphous, facts and circumstances test used under the similar property standard. Further, modifications to the like kind standard for real property could be made so that nonrecognition treatment is granted to only those transactions that can reasonably be viewed as resulting in an insignificant change in a taxpayer’s position, although this will require a balancing of the administrative costs involved. The next subsection examines this issue.

132. *See supra* notes 89-93 and accompanying text.

133. *See supra* notes 118-22 and accompanying text; *see also supra* note 96 (barge and tug not similar property, but generally are of like kind).

134. Among the asset groupings under the like kind regulations are the following categories: office furniture, fixtures, and equipment; computers and peripheral equipment; automobiles and taxis; buses; light general purpose trucks; and heavy general purpose trucks. *See* Treas. Reg. 1.1031(a)(2)-2(b)(2) (2001).

135. *See supra* note 110 and accompanying text.

b. Modifying the Like Kind Standard

Much criticism has been leveled against the broad standard applicable to real estate under the like kind rule, which treats almost all real property as like kind.¹³⁶ Indeed, in 1989, Congress considered, but did not adopt, a provision that would have replaced the like kind standard with the narrower similar property standard in order to limit the situations where real property transactions qualify for nonrecognition treatment.¹³⁷

From the standpoint of efficiency, the broad like kind test for real property may not be justifiable given that exchanges of dissimilar real property may not involve the degree of tax elasticity that arguably warrants nonrecognition treatment.¹³⁸ Furthermore, more liberal nonrecognition treatment for real property, as compared to personal property (for which the like kind standard is narrower),¹³⁹ may create a tax incentive for investing in real property over personal property, possibly resulting in additional efficiency costs at Time One.¹⁴⁰ The efficiency consequences of a broad like kind standard for real property are far from certain, however. First, it is not clear that having a more stringent like kind test for real property would promote efficiency. While an exchange of similar real properties may be more tax-elastic, a dissimilar realty exchange may be tax-elastic enough to warrant nonrecognition treatment; there appears to be a lack of empirical data on tax elasticities to support either a broad or narrow standard for real property.¹⁴¹ Second, whether a broader like kind standard for real property vis-à-vis personal property provides a tax incentive for investing in real property is complicated by other differences in the tax treatment of real and personal property. Real property is subject to more favorable treatment under the at-risk¹⁴² and passive loss¹⁴³ rules, and it is generally

136. See e.g., Shaviro, *supra* note 17, at 44; Kornhauser, *supra* note 2, at 449; STANLEY S. SURREY ET. AL., *FEDERAL INCOME TAXATION: CASES AND MATERIALS* 800 (Successor ed. 1986); Jensen, *supra* note 10, at 207.

137. See H. R. REP. NO. 101-247, at 1339-42 (1989). The Clinton Administration made an identical proposal in 1997. See Joseph G. Howe, III, *Inside Washington: Beware of Tax Simplification*, REAL EST. TAX DIG. 183, 208 (June 1997).

138. See Shaviro, *supra* note 17, at 44. See *supra* notes 49-59 and accompanying text for a discussion of the efficiency case for the like kind rule.

139. See *supra* notes 110-17 and accompanying text.

140. See *supra* notes 54-56 and accompanying text for a discussion of Time One efficiency effects.

141. See *supra* notes 90-91 and accompanying text.

142. See I.R.C. § 465(b)(6) (2000) (allowing at risk amounts for certain non-recourse debt incurred in connection with the activity of holding real property).

143. See *id.* § 469(c) (providing special treatment to rental real estate activities of certain taxpayers engaged in real property businesses).

acknowledged that personal residences receive generous treatment under the Code in order to encourage home ownership;¹⁴⁴ personal property, however, probably receives greater benefits under the accelerated depreciation rules.¹⁴⁵ Consequently, in light of these other disparities in tax treatment, it is not clear whether more liberal like kind treatment for real property exchanges creates an overall tax incentive for investing in real estate as opposed to personal property.

Nonetheless, although lacking in certainty, reasonable assumptions about tax elasticities suggest that the current like kind standard for realty is too broad.¹⁴⁶ Reasonable assumptions should have some value in the absence of empirical data, given that decisions regarding nonrecognition rules (such as whether to have them and what features they should contain) must be made.¹⁴⁷ Further, anecdotal evidence tends to confirm that taxpayers often use like kind exchanges of real estate as a substitute for taxable sales rather than for retaining the property.¹⁴⁸ Similarly, the application of the broad like kind standard for realty to involuntary conversions appears to be questionable on perceptual horizontal equity grounds; where a taxpayer goes from holding one piece of real estate (e.g., unimproved rural land) to a piece of dissimilar realty (e.g., a city apartment building), the situation looks more like a change of investments than the continued holding of the same property.

Thus, there appear to be fairly strong efficiency and equity arguments for tightening the like kind test for real property. Such a move is bound to create

144. See, e.g., GRAETZ & SCHENK, *supra* note 13, at 347, 654 (noting this as the stated policy goal for the home mortgage interest deduction; pointing out that the exclusion and deductions relating to personal residences amount to a significant tax expenditure). This includes the exclusion of gain under Section 121 on the disposition of a principal residence, the deductibility of mortgage interest expense under Section 163(h), and the fact that the imputed income on owner-occupied housing is not subject to tax. The tax benefits associated with home ownership may at first seem irrelevant to the efficiency consequences of allowing a broad like kind test for real property, because personal residences are not eligible for like kind treatment as result of the holding requirement. See I.R.C. § 1031(a)(1) (2001). It may not be very difficult, however, to convert a personal residence to investment property in order to take advantage of the like kind rules. Moreover, as discussed subsequently, this Article recommends the elimination of the holding requirement. See Part V.D.4 for a thorough discussion of these points.

145. Cf. JAMES J. FREELAND ET AL., *FUNDAMENTALS OF FEDERAL INCOME TAXATION* 439, 441-42 (12th ed. 2002) (noting that the Tax Reform Act of 1986 generally allowed more generous depreciation on personal property, while extending the recovery period and mandating the use of the straight-line depreciation method for real property).

146. See Shaviro, *supra* note 17, at 44, 65.

147. See Shaviro, *supra* note 17, at 65.

148. See Shaviro, *supra* note 17, at 44.

additional complexity, however, and, therefore, the administrative consequences need to be considered. For reasons expressed earlier,¹⁴⁹ administrative considerations counsel against using a similar property-like approach for realty that would require a fact-intensive analysis of the physical characteristics, uses, and possibly locations of the relinquished and replacement real estate.¹⁵⁰ A more acceptable standard would be one that employs a categorization approach like that used under the like kind standard for personal property.¹⁵¹ Of course, such a categorization approach could take several forms. One possibility would be to use a categorization approach that is modeled on the classifications of real property for depreciation purposes; that is, all real property (including the land on which improvements are placed) would fall into one of several categories—residential rental property,¹⁵² nonresidential real property,¹⁵³ several categories of specialized realty,¹⁵⁴ land improvements,¹⁵⁵ and unimproved real property. A more refined and narrow approach would be to divide real property among many categories, such as office buildings, apartment houses, hotels, theaters, oil wells, and vacant land just to name some of the possible categories.¹⁵⁶ In either case, it would be advisable for Congress to provide the IRS and Treasury with the authority to publish a detailed description of the categories, as is done for purposes of the depreciation rules and the personal property like kind regulations, rather than having taxpayers and the IRS grapple over language in committee reports that either suggests possible categories or provides some examples of situations qualifying for nonrecognition treatment.¹⁵⁷

149. See *supra* notes 118-27 and accompanying text.

150. Cf. Rev. Rul. 70-399, 1970-2 C.B. 164 (relinquished and replacement hotels not similar where taxpayer operated one and leased the other).

151. See *supra* notes 111-17 and accompanying text.

152. See I.R.C. § 168(e)(2)(A) (2000).

153. See *id.* § 168(e)(2)(B).

154. Among the categories of specialized realty could be categories for agricultural and horticultural structures, other farm buildings, most theme and amusement park structures, and railroad gradings or tunnel bores. Cf. *id.* § 168(e), (i); Rev. Proc. 87-56, 1987-2 C.B. 674 (specifying such categories for depreciation purposes).

155. As is the case for depreciation purposes, this could be a single category that contains sidewalks, roads, canals, waterways, drainage facilities, sewers, wharves and docks, bridges, fences, and radio and transmitting towers, among other items. See Rev. Proc. 87-56, 1987-2 C.B. 674. Alternatively, if it is not too administratively burdensome, this could be divided into multiple categories.

156. In its explanation of a 1989 proposal to replace the like kind standard with the similar property standard, the House Report appears to suggest such a categorization approach, rather than a “pure” similar property standard, for applying Section 1031 to real property exchanges. See H.R. REP. NO. 101-247, at 1340-41 (1989), *reprinted in* 1989 U.S.C.C.A.N. 1906, 2810-11.

157. In this regard, the House Report’s explanation of the 1989 proposal to replace

A categorization approach for real property, however, would not necessarily be without administrative difficulties. Issues may arise as to which category applies, especially with respect to real property with more than one use; obviously, the more categories that there are, the greater the number of such issues that would arise. Administratively, an approach modeled on the current classifications for depreciating real property is the better choice. Under this approach, it should be clear as to the appropriate category in the vast majority of cases given that the classifications are defined by objective criteria. As an example, residential rental property is defined as any building or structure if for the relevant taxable year eighty percent or more of the gross rental income from the realty is rental income from dwelling units.¹⁵⁸ Moreover, under this approach a substantial portion of real property should fall within the nonresidential real property category, as this category includes buildings or structures, other than residential rental property, with a class life of least 27.5 years. Therefore, in many situations the particular use of the real property would be irrelevant; for example, regardless of whether a structure houses a bowling alley, a restaurant, or offices, it would be treated as nonresidential real property.¹⁵⁹

the like kind standard with the similar property standard merely states that an exchange of improved properties of different uses generally would not qualify for nonrecognition treatment, and provides a few examples, without giving the IRS the authority to issue a comprehensive list of categories. *See id.*

158. *See* I.R.C. § 168(e)(2)(A) (2000). Excluded from this category are hotels, motels, and other buildings more than half of the dwelling units in which are used on a transient basis. *See id.*

159. With such a categorization approach for real property, it may be necessary to develop anti-abuse rules to deal with situations where a taxpayer constructs relatively minor improvements on previously unimproved real property in order to have the property fall within one of the improved realty categories, in particular, the nonresidential real property category. For example, in the absence of anti-abuse rules, under a broad categorization approach a taxpayer may be able to qualify what is essentially vacant land as nonresidential real property simply by constructing a small warehouse; the taxpayer could then dispose of the land and warehouse and acquire a hotel (which would also be treated as nonresidential real property) in a like kind transaction. While the IRS may be able to disqualify this transaction from receiving Section 1031 treatment by invoking common law substance over form principles, it may be better to develop specific anti-abuse rules for this situation. A possible approach would be to disregard buildings and structures for purposes of determining whether property is nonresidential real property where the fair market value of the improvements is below a certain percentage of the fair market value of the land. This rule may also need to be used for the residential rental property category and possibly other categories as well. Alternatively, a categorization approach for real property could treat land and improvements therein as separate properties, and, thus, a disposition of improved realty would be treated as a multiple asset disposition. *See supra* notes 128-29 and accompanying text for a discussion of the like kind regulations dealing with multiple asset exchanges. While fragmented treatment of

Whether and how to modify the like kind standard for real property involves a balance of competing policies. While a more narrow standard should promote the underlying policies of efficiency and equity, any narrowing of the standard would result in increased complexity. The use of a categorization approach along the lines of the real property depreciation classifications would appear to strike the appropriate balance. To be sure, the use of this approach, with a broad default category like nonresidential real property, would still allow nonrecognition treatment for some transactions that would appear to result in a significant change in a taxpayer's position, such as the exchange of a hotel for an office building;¹⁶⁰ consequently, to further advance efficiency and equity, albeit with additional administrative costs, consideration should be given to carving out of the nonresidential real property category a few (or several) well-defined categories, some examples being hotels and motels, theaters, and shopping malls. In either case, the use of this standard would prevent like kind treatment for the transactions with clear nontax significance—for example, an exchange of vacant land for an apartment building, or an exchange of a farmland and related structures for a motel. And, while a multi-category standard for real property would be more intricate and generate more uncertainty than current law's one category approach, the use of objective, well-defined categories should result in an administratively acceptable approach, as is the case with the like kind personal property regulations.¹⁶¹ For these reasons, this Article recommends that the like kind standard for real property be narrowed by employing a categorization approach along the lines of the real property classifications used for depreciation purposes.¹⁶²

land and improvements obviates anti-abuse rules aimed at disregarding minor improvements to land, such an approach would require that land and improvements be separately valued for purposes of applying the multiple asset exchange regulations, which could lead to valuation disputes between taxpayers and the IRS.

160. It is important to point out that while the land and structures in this situation would be treated as of like kind, any personal property involved in the exchange (the contents of the building and goodwill) would not necessarily be so treated under the like kind test for personal property. Thus, assuming the exchange of the real estate involves related personal property, it is likely that some gain would be required to be recognized under the multiple property exchange regulations. See Treas. Reg. § 1.1031(j)-(1) (2001) and notes 128-29 and accompanying text for a discussion of these regulations.

161. As with the use of depreciation and industrial classifications for the personal property like kind standard, the use of rules similar to the real property depreciation classifications for the real property like kind standard would provide an additional administrative benefit: it would allow for the use of one set of rules, or at least similar rules, for both depreciation and like kind purposes. See *supra* notes 42, 103-07 and accompanying text for a discussion of the administrative burdens that result from having duplicative tax rules.

162. As additional modifications, in two respects the like kind standard should be

broadened in its application to involuntary conversions. Under current law, a taxpayer qualifies for nonrecognition treatment upon an involuntary conversion where the proceeds of the conversion are used to repair property damaged in the conversion, or to improve or rearrange other property owned by the taxpayer, as long as the improved or rearranged property is similar to the converted property. *See, e.g.*, Rev. Rul. 67-254, 1967-2 CB. 269. There appears to be no reason why nonrecognition treatment should not continue to be granted in these situations with the use of the like kind standard, provided that doing so does not present serious administrative difficulties. Without a technical modification, however, taxpayers may fail to satisfy the like kind standard in these situations, at least with regard to realty, given that the IRS has ruled that improvements constructed on previously owned real property are not of like kind to land and improvements for purposes of applying Section 1033(g) to involuntary conversions. *See* Rev. Rul. 71-41, 1971-1 C.B. 223. Consequently, it is recommended that taxpayers be allowed nonrecognition treatment upon an involuntary conversion where they reinvest the conversion proceeds in previously owned property, provided that after the reinvestment the property is of like kind to the property that is converted. It should be noted, however, that the recommended modification to the application of the like kind standard may not result in the same treatment that is currently accorded under the similar property standard. Under current law, a taxpayer may receive nonrecognition treatment under the similar property standard where she uses the conversion proceeds to acquire new property, or to invest in previously owned property, that, when used in connection with other previously owned property, renders the integrated properties as similar to the converted property. The recommended approach would allow nonrecognition treatment in this situation only if the newly acquired or invested in property is of like kind to the converted property. To do otherwise would require an administratively difficult facts and circumstances approach that compares the functions of the integrated properties to that of the converted property.

The limited coverage of the like kind rule necessitates another modification to the like kind standard as it applies to involuntary conversions. As noted earlier, the like kind rule is inapplicable to the disposition of financial assets such as stocks, bonds, notes, and partnership interests. *See* I.R.C. § 1031(a)(2) (2000). Instead, several other Code provisions provide nonrecognition treatment for certain voluntary exchanges involving financial assets. *See, e.g., id.* § 1037 (certain exchanges of United States obligations), *id.* § 354 (exchanges of stock and securities in connection with a reorganization), *id.* § 1036 (exchanges of stock in the same corporation). As a consequence, there are no like kind tests pertaining to such financial assets. The involuntary conversion rule, however, does not have any exceptions for financial assets, and occasionally these items are involuntarily converted. *See, e.g.,* Priv. Ltr. Rul. 82-33-144 (May 24, 1982) (dealing with the condemnation of stock in a private utility). Therefore, it is recommended that the similar property standard be kept alive as a supplement to the like kind standard for situations involving the involuntary conversion of financial assets. While this would require a fact-intensive analysis to determine the eligibility of replacement property in these situations, involuntary conversions of financial assets appear to be relatively rare, and, thus, the administrative burdens should not be large.

B. The Exchange Requirement Under the Like Kind Rule

Under the like kind rule, only an exchange of like kind properties can qualify for nonrecognition treatment. The exchange requirement under current law, however, is a mere formality; the like kind rule really employs an effective rollover mechanism, given that the regulations,¹⁶³ through a series of complicated rules, effectively permit taxpayers to sell one property for cash and use the proceeds to purchase a second property.¹⁶⁴ Moreover, an exchange requirement, whether real or formal, is not a necessary ingredient for a nonrecognition provision; the involuntary conversion rule,¹⁶⁵ along with a few other nonrecognition provisions,¹⁶⁶ do not require an exchange and instead expressly allow taxpayers to dispose of property for cash and use the proceeds to acquire qualifying property. There would appear then to be three possibilities for linking the disposition and acquisition of properties under the like kind rule: (i) a real or simultaneous exchange requirement, (ii) an effective rollover mechanism, and (iii) an express rollover mechanism. This section seeks to determine which of these approaches is best supported by fundamental tax policies.

The efficiency rationale for the like kind rule suggests that there should be adequate linkage between the disposition of the relinquished property and the acquisition of the replacement property. According to the efficiency rationale, nonrecognition is accorded like kind transactions so that taxpayers will not refrain from engaging in dispositions and related acquisitions that are relatively tax-elastic. Thus, the efficiency basis suggests that nonrecognition should only apply where the disposition and the acquisition are factually linked. Looking for actual linkage, however, would necessitate an inquiry into a taxpayer's subjective intent, an administratively burdensome task. Instead, a surrogate for actual linkage can be a requirement that the relinquished property be simultaneously exchanged for the replacement property. Another surrogate can be a rollover rule that requires that the replacement property be acquired within a reasonable period preceding or following the disposition of the relinquished property.¹⁶⁷ Either measure appears to be consistent with the efficiency basis for

163. Treas. Reg. § 1.1031(k)-1 (2001).

164. See STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 12, at 301.

165. Given that taxpayers receive cash proceeds in most involuntary conversions, an exchange requirement would render the provision of little use.

166. See I.R.C. § 1044 (2000) (allowing rollover of publicly traded securities gain into specialized small business investment companies); *id.* § 1045 (allowing rollover of gain from qualified small business stock to another qualified small business stock). In addition, former Section 1034 allowed rollover of gain on a sale of a principal residence. *Id.* § 1034 (repealed 1997).

167. Part V.C, *infra*, examines the considerations involved in setting the length of replacement periods under the like kind and involuntary conversion rules.

the like kind rule, given that they both allow for a reasonable inference of actual linkage.

The efficiency rationale, however, does not indicate with reasonable certainty which of these measures is more beneficial. On the one hand, the Time Two efficiency benefits that result from the application of the like kind rule are as likely to occur with a planned sale and re-investment as they are with a simultaneous exchange of properties. That is, if, because of tax elasticity, an exchange of one property for another would be deterred, a related sale and reinvestment involving the same properties would similarly be deterred. A simultaneous exchange requirement would ensure that a disposition and acquisition are factually related, and, thus, prevents nonrecognition treatment for dispositions that are relatively tax-inelastic, but happen to be followed by unrelated acquisitions that give the overall appearance of a tax-elastic transaction: for example, where a taxpayer sells unimproved real property for the purpose of consuming the proceeds but subsequently changes her mind and acquires a different tract of unimproved realty. A simultaneous exchange requirement, however, is clearly underinclusive in detecting the factual connection between dispositions and acquisitions—in many cases not involving exchanges, dispositions are made with the intent of making a specific acquisition. Moreover, while some taxpayers would structure related dispositions and acquisitions as three-cornered exchanges in order to satisfy a simultaneous exchange requirement,¹⁶⁸ the associated transaction costs may deter other taxpayers from disposing of property, thereby resulting in lower Time Two efficiency benefits with a like kind rule that contains a simultaneous exchange requirement. It would appear then that a rollover mechanism, either express or effective, rather than a simultaneous exchange requirement, would more accurately target related dispositions and acquisitions, provided that the time period for replacing relinquished property is reasonably limited.¹⁶⁹ On the other hand, the use of a rollover mechanism increases the Time Two efficiency costs by increasing the number of like kind transactions occurring solely for tax reasons.¹⁷⁰ That is, because a rollover mechanism provides a great amount of flexibility in acquiring new property whereas a simultaneous exchange requirement tends to limit re-investment options, the use of either an express or effective rollover mechanism should result in more situations where taxpayers enter into like kind transactions as a substitute for what would otherwise be cash sales on non-like exchanges.

168. See *infra* notes 181-85 and accompanying text.

169. Cf. Willis, *supra* note 11, at 92-93 (arguing for rollover in lieu of the exchange requirement based on effectuating the continuity of investment policy that underlies Section 1031); Jensen, *supra* note 10, at 207 (same).

170. See Shaviro, *supra* note 17, at 44.

In sum, while the use of an express or effective rollover mechanism, rather than a simultaneous exchange requirement, likely results in Time Two benefits by more accurately providing nonrecognition to related dispositions and acquisitions that would otherwise be deterred by current taxation, it also should result in increased Time Two costs by causing taxpayers to make re-investments that are motivated purely by tax considerations. Deciding whether to use an effective rollover mechanism versus an express rollover mechanism also involves an evaluation of efficiency tradeoffs; the greater transaction costs associated with a like kind rule employing an effective rollover mechanism would likely result in both lower Time Two benefits, because some tax-elastic transactions would be deterred, as well as lower Time Two costs, because some tax motivated transactions would be curbed. Given the apparent dearth of information on tax elasticities and welfare losses,¹⁷¹ the overall efficiency effects of these alternatives are uncertain.

With the uncertainty of efficiency analysis, tax administration concerns should be of prime importance in deciding among the possible approaches for linking dispositions and acquisitions under the like kind rule. In this regard, the effective rollover mechanism employed in the deferred exchange regulations appears to be the worst of the available options. These regulations require taxpayers to comply with a series of complicated rules in order to maintain the form of an "exchange" for transactions that effectively amount to a sale of one property and acquisition of another. To elaborate, the regulations allow a taxpayer to transfer property to a "qualified intermediary," who then can sell the property for cash, acquire like kind property at the taxpayer's direction, and transfer the like kind property to the taxpayer.¹⁷² Alternatively, a taxpayer could transfer the property to the buyer, who then purchases like kind property that the taxpayer designates and transfers the property to the taxpayer. Because any money or other property received by a taxpayer's agent is attributed to the taxpayer, the regulations contain detailed rules distinguishing a qualified intermediary from an agent.¹⁷³ The regulations also contain intricate rules that provide safe harbors so that taxpayers can avoid being treated as actually or constructively receiving money as a result of arrangements securing the buyer's performance.¹⁷⁴ A recently released revenue procedure provides an additional set of complex requirements that, if satisfied, allow taxpayers to acquire the replacement property prior to the disposition of the relinquished property.¹⁷⁵ The

171. See *supra* notes 58, 90-91 and accompanying text.

172. See Treas. Reg. § 1.1031(k)-1 (2001).

173. See *id.* § 1.1031(k)-1(g)(4)(iii).

174. See *id.* § 1.1031(k)-1(g)(1). Included among the safe harbors are security or guarantee arrangements and qualified escrow accounts and trusts. See *id.*

175. See Rev. Proc. 2000-37, 2000-40 I.R.B. 308.

rules are quite intricate, thereby placing substantial burdens on taxpayers and their advisers in understanding them, and on the IRS in administering them. They also present uncertainties; for example, there appear to be several unanswered questions concerning a taxpayer's access to escrowed funds,¹⁷⁶ and, indeed, one commentator points out that many deferred exchanges will raise issues that are not directly addressed in the regulations.¹⁷⁷ Furthermore, as a result of the rules' complexity, taxpayers incur additional transaction costs for tax advice and facilitator services.¹⁷⁸ Because the effect of the deferred exchange regulations is to allow rollover treatment, it seems easy to dismiss these rules as purposeless formalism and complexity—similar substance could be achieved through a simple, express rollover rule.¹⁷⁹ For this reason, the staff of the Joint Committee on Taxation recommends that the exchange requirement, as well as the deferred exchange regulations, be replaced with an express rollover rule.¹⁸⁰

Requiring simultaneous exchanges, another possible approach, would also lead to significant complexity. With such a requirement, it is inevitable that taxpayers would still structure multiparty exchanges. Indeed, this was the case before the courts and Congress allowed deferred like kind exchanges. For example, if taxpayer A wants to dispose of her commercial building and acquire an apartment building, she can enter into an arrangement where she agrees to transfer the commercial building to buyer B and buyer B agrees to purchase an apartment building that A has designated and transfer the property to A. Buyer B then acquires the apartment building and transfers it to taxpayer A in exchange for A's commercial building, completing a simultaneous like kind exchange. Thus, a simultaneous exchange requirement would still engender tax planning and its attendant costs.¹⁸¹ Furthermore, there would be uncertainty and

176. See James R. Hamill, *Avoiding Traps in Deferred Like-Kind Exchanges*, TAX ADVISER, Nov. 1, 1997, at 716, 718 (noting several open issues).

177. *Id.*

178. STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 12, at 302; see also Richard M. Lipton, *The "State of the Art" in Like-Kind Exchanges*, 91 J. TAX'N 78, 79 (1999) (pointing out that the deferred exchange regulations have resulted in the creation of an entire industry to assist taxpayers in completing nontaxable deferred exchanges).

179. Cf. Harroch, *supra* note 67, at 362-63 (pointing out that deferred, three-way exchanges are in substance identical to a sale and reinvestment into like kind property). As mentioned previously, there would likely be some efficiency tradeoffs in using an express as opposed to effective rollover rule. See *supra* note 171 and accompanying text.

180. See STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 12, at 302. Likewise, House Ways and Means Committee member Amos Houghton recently introduced a bill that includes a provision allowing for the use of express rollover under the like kind rule. Individual and Small Business Tax Simplification Act of 2002, H.R. 5505, 107th Cong. (2002).

181. See Harroch, *supra* note 67, at 363-64 (detailing extra transaction costs necessitated by a simultaneous exchange requirement).

controversy as well, as illustrated by the series of court cases dealing with multiparty, simultaneous exchanges (most involving taxable years ending before the effective date of the deferred exchange regulations).¹⁸² The difficulties stem from the tension involved in many multiparty, simultaneous exchanges: that is, at some point the situation may more closely resemble a taxable sale and reinvestment rather than a nontaxable simultaneous exchange. Thus, controversies have arisen over whether a buyer should be treated as a taxpayer's agent,¹⁸³ and whether a taxpayer should be considered in constructive receipt of escrowed funds.¹⁸⁴ With a simultaneous exchange requirement in lieu of current law's effective rollover mechanism, the uncertainties and controversies that were prevalent prior to the adoption of the deferred exchange regulations would likely resurface. While this approach may deter some taxpayers from engaging in multi-party exchanges, there would likely be a substantial amount of activity in this area, with resulting uncertainty, controversy, and costly tax planning.¹⁸⁵

By far, the simplest of the three options is to permit express rollover under the like kind rule. An express rollover mechanism would avoid the intricacy and uncertainty of the other approaches, as taxpayers wanting to sell property and reinvest the proceeds into like kind property could do so directly without engaging in complicated multi-party exchanges designed to meet either a deferred or simultaneous exchange requirement.¹⁸⁶ This approach should also reduce the

182. See, e.g., *Biggs v. Commissioner*, 69 T.C. 905, 919 (1978), *aff'd*, 632 F.2d 1171 (5th Cir. 1980).

183. See, e.g., *Rutland v. Commissioner*, 36 T.C.M. (CCH) 40 (1977); *Everett v. Commissioner*, 37 T.C.M. (CCH) 274 (1978).

184. See, e.g., *Garcia v. Commissioner*, 80 T.C. 491 (1983), *acq.*, 1984-2 C.B. 1 (1984); *Klein v. Commissioner*, 66 T.C.M. (CCH) 1115 (1993).

185. Indeed, even before the allowance of deferred exchanges, the multi-party exchange area was referred to as the "hottest topic . . . among small and large scale investors." See Stanley Weiss & Howard J. Levine, *Multi-party Exchanges: Despite Recent Cases, Careful Attention to Details is Necessary*, 7 J. REAL EST. TAX'N 203, 203 (1980).

186. See STAFF OF JOINT COMM. ON TAXATION, *supra* note 12, at 302 (referring to the reduced complexity that would result from replacing the effective rollover mechanism with an express one). It should be pointed out that the Federation of Exchange Accommodators ("FEA"), a national trade organization that represents qualified intermediaries, has argued that qualified intermediaries protect government revenues by performing functions that would otherwise have to be performed by the IRS at the public's expense. See Lisa Pfenniger, *Like Kind Exchanges: Exchange Association Officer Says Group Should Oppose Section 1031 Simplification*, DAILY TAX REPORT G-3 (October 29, 2002). Even if the need under the current rules for professionals to assist in like kind exchanges does relieve the IRS of some of its auditing responsibilities, which appears to be a debatable point, this only means that taxpayers (through the fees charged for these exchange services), rather than the IRS, bear a portion of the administrative

amount of tax planning involved with like kind transactions and thereby lower transaction costs.

With efficiency providing limited guidance, administrability should be the deciding factor in selecting the approach for linking acquisitions and dispositions under the like kind rule. Because an express rollover mechanism is clearly superior in this regard, this Article recommends its use in connection with the like kind rule.¹⁸⁷

burden of the effective rollover mechanism—the burden, however, still remains. In contrast, by substituting an express rollover provision for the effective rollover mechanism, the aggregate administrative burden for taxpayers and the government should be reduced. And, with express rollover, taxpayers may still need professional services in locating suitable property and advising on the tax consequences; thus, some shifting of the administrative burden from the IRS to taxpayers may continue to occur, but with a reduced overall burden for the taxpayers and the government. If it is viewed as appropriate to shift a greater portion of the administrative costs associated with a like kind rule employing express rollover to those taxpayers that use the provision, there are more sensible alternatives than retaining the complexity of the effective rollover mechanism solely to compel taxpayers to seek professional assistance. For example, express rollover could be coupled with a process under which taxpayers would be required to obtain certification from a licensed third party that there has been a timely acquisition of like kind replacement property. Another possibility would be to impose a user fee on taxpayers who apply the like kind rule in reporting their tax liabilities.

187. This Article's analysis of the like kind rule has focused on the rule's application to dispositions of appreciated property. Although the like kind rule currently results in nonrecognition of losses on like kind exchanges involving depreciated property, it should be fairly easy for taxpayers to avoid the nonrecognition of losses by selling the relinquished property to one party and acquiring the replacement property from another party—that is, by avoiding an exchange. *See Willis, supra* note 11, at 88-89. Thus, the nonrecognition of loss under current law appears to be merely a trap for the unwary. *See id.* Nevertheless, in connection with adopting an express rollover rule for like kind transactions involving appreciated property, some consideration should be given to applying this rule to dispositions involving depreciated property as well. *Cf. Thomas L. Evans, The Realization Doctrine after Cottage Savings*, 70 TAXES 897, 901-02 (1992) (recommending that the like kind rule employ a rollover provision that would apply to both gain and loss property). Similar to an efficiency analysis of the wash sale provision contained in Section 1091, the efficiency case for applying the like kind rollover rule to loss property would appear to depend on whether such an approach would deter selective realization of losses for tax purposes to a greater extent than it encourages waiting longer to acquire like kind property. *Cf. Shaviro, supra* note 17, at 47-48 (analyzing the efficiency case for the wash sale rule).

C. Replacement Periods

As discussed in the previous Part, this Article recommends that the like kind rule expressly permit taxpayers to sell property and use the proceeds to acquire like kind property.¹⁸⁸ Also, for practical reasons, express rollover should continue to be allowed under the involuntary conversion rule.¹⁸⁹ Consequently, issues arise as to the appropriate replacement periods for like kind transactions and involuntary conversions in light of fundamental tax policies.

Under current law, the period for replacing involuntarily converted property is generally two years after close of the taxable year in which the conversion occurs.¹⁹⁰ This period is extended to three years for condemnations of business or investment real property.¹⁹¹ While the like kind rule currently does not allow for express rollover treatment, the rules for deferred exchanges effectively allow rollover treatment, with the requirement that the replacement property be (i) identified within 45 days of the transfer of the relinquished property and (ii) acquired within the earlier of 180 days after the transfer of the relinquished property or the due date for filing the return (with extensions) for the year of disposition.¹⁹² Recently, the IRS has also permitted taxpayers to acquire the replacement property before the disposition of the relinquished property in some circumstances.¹⁹³

In addressing the replacement period for like kind transactions, the methodology for reform developed earlier indicates that efficiency and tax administration considerations should be taken into account. As discussed earlier, a rollover mechanism is consistent with the efficiency rationale for the like kind rule to the extent that it serves as a surrogate for actual linkage between the disposition of the relinquished property and the acquisition of the replacement property.¹⁹⁴ Actual linkage can reasonably be inferred when the delay in acquiring the replacement property is no greater than the time required to locate and acquire the like kind property. Consequently, efficiency concerns indicate that such a time period should be selected as the replacement period for like kind transactions.

With regard to administrability, problems could result if the replacement period is permitted to go beyond the date for filing the tax return for the year of

188. *See supra* Part V.B.

189. *See supra* note 165.

190. *See* I.R.C. § 1033(a)(2)(B)(i) (2000).

191. *See id.* § 1033(g)(4). In addition, the IRS may extend the replacement period upon application by a taxpayer. *See id.* § 1033(a)(2)(B)(ii).

192. *See id.* § 1031(a)(3).

193. *See* Rev. Proc. 2000-37, 2000-40 I.R.B. 308.

194. *See supra* note 167 and accompanying text.

the disposition. For example, in situations where a taxpayer acquires some of the replacement property during the taxable year of the disposition, but is permitted to acquire additional replacement property after the return due date for that year, it would not be possible to determine the adjusted basis of the already acquired property, as well as depreciation deductions with respect to that property (if it is depreciable), by the return due date for that year. More generally, if the replacement period were to extend beyond the return due date for the year of the disposition, taxpayers would be required to file amended returns for the year of the disposition where like kind property was not acquired within the replacement period, thus, necessitating rules extending the statute of limitations on assessing taxes attributable to the failure to timely replace the relinquished property.¹⁹⁵ For the former reason and presumably the latter as well, the exchange period limitations applicable to deferred like kind exchanges require that the replacement property be acquired no later than the due date for filing the return (with extensions) for the year of the disposition.¹⁹⁶

Taken together, these considerations call for a replacement period that allows a taxpayer the time required to locate and acquire like kind property, provided the period does not extend beyond the return due date for the year of the disposition. One approach that may satisfy these conditions would be to use a bifurcated method that is similar to the approach used currently for deferred like kind exchanges: separate periods for identifying and acquiring the replacement property.¹⁹⁷ Requiring a taxpayer to identify the replacement property at or near the time of the disposition may be more in line with the efficiency rationale for nonrecognition treatment; according to this policy basis for nonrecognition, the taxpayer has, at the time of the disposition, already made up her mind to acquire insignificantly different property. Nonetheless, there may be many properties that fall within this "insignificantly different" class and, thus, identifying property could take some time. Moreover, an identification requirement with little time and freedom to decide on replacement property could result in efficiency costs, given that taxpayers may delay disposition of the relinquished property in situations where they need more time to locate replacement property. Perhaps more importantly, administrative considerations counsel against using a bifurcated approach. An identification requirement with some flexibility, such as the three-property,¹⁹⁸ 200-percent,¹⁹⁹ and 95-percent²⁰⁰

195. Cf. I.R.C. § 1033(a)(2)(C), (D) (extending the limitations period for assessing taxes that are attributable to involuntary conversions).

196. See H.R. REP. NO. 98-432, pt.2, at 1233-34 (1984); S. PRT. NO. 98-169, Vol. I, at 243-44 (April 2, 1984).

197. See *supra* note 192 and accompanying text.

198. Under the three-property rule, a taxpayer may identify up to three properties, without regard to their fair market values. Treas. Reg. § 1.1031(k)-1(c)(4)(i)(A) (2001).

199. Under the 200-percent rule, a taxpayer may identify any number of properties,

rules used under current law, can lead to uncertainties and complications in its application.²⁰¹ Even if a “one property” identification rule were employed, controversies may still arise in situations where the property is subject to change after its identification but prior to its acquisition, such as with property to be constructed.²⁰²

Although possibly sacrificing some theoretical accuracy, on balance the better approach would be to have a single time period within which like kind property must be acquired. Regarding the specific period, while the time required to locate and acquire like kind property is somewhat uncertain, it would seem that allowing taxpayers in the order of six months would be adequate and not overly generous.²⁰³ A six-month replacement period would also be within the return filing deadline (including extensions) for the year of the disposition. To allow some flexibility for situations where the replacement property needs to be acquired before the disposition of the relinquished property, it is recommended that taxpayers be permitted to acquire the replacement property up to six months before the disposition of the relinquished property, similar to the recently authorized practice of permitting reverse exchanges under the deferred exchange rules.²⁰⁴ Presumably for similar reasons, the staff of the Joint Committee on Taxation, in proposing express rollover treatment for like kind transactions, would allow taxpayers to acquire like kind property within 180

provided that the aggregate fair market value of identified properties as of the end of the identification period does not exceed 200 percent of the aggregate fair market value of the relinquished properties as of the date of the transfer to the other party. Treas. Reg. § 1.1031(k)-1(c)(4)(i)(B) (2001).

200. Under the 95-percent rule, any property that is timely identified and received by the taxpayer will satisfy the identification requirement so long as the taxpayer timely receives identified property whose fair market value is at least ninety-five percent of the aggregate fair market value of all of the identified properties (with fair market values determined on the earlier of the date that the property is received by the taxpayer or the end of the exchange period). Treas. Reg. § 1.1031(k)-1(c)(4)(ii)(B) (2001).

201. For example, in applying the 200-percent and 95-percent rules, it may be difficult to determine the fair market values of the identified properties. See Hamill, *supra* note 176, at 720 (recommending that taxpayers use the seller’s asking price in planning with regard to the 200-percent rule).

202. *Cf. id.* at 721 (noting the special problems presented by property to be constructed in light of the regulations’ requirement that the property received be substantially the same as the property identified).

203. This is the acquisition period under the current rules for deferred like kind exchanges, and there is no indication from taxpayers or practitioners that this period is inadequate.

204. See *supra* note 193 and accompanying text.

days before or after the date of the relinquished property's disposition, but not later than the return due date for the year of the disposition.²⁰⁵

Similar considerations apply in determining the appropriate replacement period for involuntary conversions. According to the perceptual horizontal equity basis for nonrecognition, a taxpayer who involuntarily converts property and acquires insignificantly different property is perceived as similarly situated to a taxpayer who continues to hold the same property. Treating an involuntary converter like a continued holder only seems proper, however, where the period of forced divestment does not exceed the time required to locate and acquire eligible replacement property; otherwise, the more appropriate comparison for an involuntary converter appears to be a taxpayer who, as a result of a forced realization, decides to change investments (or simply remain liquid), and subsequently acquires property that happens to be insignificantly different from the converted property. Consequently, the horizontal equity basis indicates that the replacement period for involuntary conversions should be the time required to locate and acquire eligible replacement property. As with respect to like kind transactions, tax administration concerns also suggest an additional consideration: that the replacement period not extend beyond the due date for filing the return for the year of the involuntary conversion.

Unlike with respect to like kind transactions, however, it may be difficult to develop a replacement period for involuntary conversions that meets both of these objectives. This is because a reasonable time period for locating and acquiring eligible replacement property upon an involuntary conversion may go beyond the return due date for the year of the conversion. Unlike the voluntary disposition situation, a taxpayer who experiences an involuntary conversion typically does not have a great deal of advance notice and, thus, the ability to begin locating eligible replacement property prior to the conversion. Moreover, a taxpayer may have difficulty in immediately beginning the task of replacing the converted property because of the possible disruption to her personal affairs and business activities as a result of the conversion. Presumably, these factors account for the longer replacement period under current law for involuntary conversions as compared to deferred like kind exchanges, as well as the fact that the replacement period for involuntary conversions extends beyond the return due date for the year of the conversion.

Nevertheless, there may be reasons for using a shorter replacement period for involuntary conversions than that used under current law, possibly one that falls within the return due date limitation. First, if, as this Article recommends, a modified like kind standard is used to determine eligible replacement property for involuntary conversions, a taxpayer may need less time to locate such property. With the more liberal like kind test as compared to the similar property

205. See STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 12, at 302.

standard, in many cases there should be more available property that would qualify as eligible replacement property. While business and investment considerations are important in deciding how to replace converted property, tax consequences also matter. Consequently, with more eligible replacement property, a taxpayer should have an easier and quicker task of locating qualifying property. On the other hand, condemnations of business or investment real property, which are probably the most common type of involuntary conversion, would be adversely affected by the changes recommended by this Article. These conversions currently get the benefit of the broad like kind standard for real property, and the proposal calls for modifications that would narrow this standard. The proposal would still provide taxpayers with a fairly liberal categorization test for real property, however, and, thus, the task of locating and acquiring eligible replacement property may not be significantly more difficult.

A more important reason for possibly shortening the replacement period for involuntary conversions is the ability of the Internet and other technological advances to facilitate the process of locating property. With the existence of websites such as eBay, prospective purchasers can readily and speedily access and search information regarding a wide array of properties. Specialized data bases are also available for real estate and other specific types of property. Retail and wholesale purchases are also facilitated by the Internet and related technologies. Consequently, while a two (or three) year replacement period may have been warranted at one time, a shorter period may suffice in today's electronic commercial environment.²⁰⁶

Nonetheless, even if a shorter rollover period for involuntary conversions is justified, there is some uncertainty as to whether using a return due date limitation would allow sufficient time to locate and acquire eligible replacement property. Perhaps a study could be performed to ascertain the percentage of taxpayers who under current law replace involuntarily converted property by the due date for filing returns for the year of the conversion. Under current law, taxpayers experiencing an involuntary conversion are required to notify the IRS on their returns²⁰⁷ that a replacement has been made or that no replacement will be made, in order to begin the running of the statute of limitations on assessment;²⁰⁸ in particular, where a replacement is made prior to the return due date for the year of the conversion, taxpayers are instructed to include a statement in their return for that year which provides details with respect to the

206. Indeed, up until 1969, Congress was of the view that a one-year replacement period was appropriate. Pub. L. No. 91-172, § 915(a), 83 Stat. 723 (1970).

207. The IRS has also allowed the designation of replacement property on an amended return. Priv. Ltr. Rul. 84-24-026 (March 12, 1984).

208. See I.R.C. § 1033(a)(2)(C) (2000).

replacement.²⁰⁹ Consequently, a study of tax return information should reveal the portion of taxpayers replacing property by the return due date for the year of the conversion.²¹⁰ That a high percentage of taxpayers replace property by this date would suggest that a replacement period with a return due date limitation would provide adequate time to replace property; a low percentage, however, does not necessarily indicate that such a replacement period would be inadequate, but would merely be inconclusive on the issue, given that taxpayers may be able to adjust to a shorter replacement period.²¹¹

209. See IRS Publication 547, at 8-11 (2001).

210. As noted above, any changes to the applicable standard would likely affect the time needed by taxpayers to locate eligible replacement property; therefore, it would be advisable to conduct this study after the effective date of any modifications to the eligible replacement property standard for involuntary conversions.

211. At least one situation involving involuntary conversions requires that there be some flexibility in the replacement period. Taxpayers involved in condemnation proceedings may sometimes contest the amount of the award. Yet, despite the contest the condemnation proceeds are generally available for withdrawals, thus, triggering the start of the replacement period. See Edwards, *supra* note 102, at A-37. Thus, taxpayers who wait until the contest is resolved to replace property may find that the replacement period has expired. It may be difficult, however, for the taxpayer to replace the condemned property while the award is still in dispute, given that the taxpayer does not know the extent of the required reinvestment; and a taxpayer who timely replaces the condemned property on the basis of the initial award would not have the ability to avoid the recognition of gain attributable to an additional award received after the expiration of the replacement period. See, e.g., *Shipes v. Commissioner*, 74 T.C.M. (CCH) 2 (1997). If the period for involuntary conversions is shortened, the problem would be even more pronounced. Current law provides a potential solution by giving the IRS discretion to extend the replacement period for an involuntary conversion upon application by a taxpayer. I.R.C. § 1033(a)(2)(B) (2000). Among the situations where the IRS has granted extensions are cases involving taxpayers in disputes over condemnation awards. See Edwards, *supra* note 102, at A-39. Allowing the IRS to continue to have such discretion may result in administrative burdens for the agency (see, e.g., Rev. Rul. 76-488, 1976-2 C.B. 244), and the courts as well to the extent that taxpayers litigate denials of extension applications. See, e.g., *Boyce v. United States*, 405 F.2d 526 (Ct. Cl. 1968). Furthermore, with the recommended generally more liberal standard for eligible replacement property, along with the enhanced ability to locate property electronically, there may not be the general need for discretionary extensions. On the other hand, the disputed condemnation award situation and other cases involving similar circumstances, such as disputes over insurance awards, do warrant a discretionary extension procedure. Consequently, it is recommended that the IRS at least be allowed to extend the replacement period in situations involving disputes over the amount of condemnation or insurance proceeds.

D. *The Holding Requirement Under the Like Kind Rule*

In addition to the like kind standard and the exchange requirement, the like kind rule contains a third basic requirement for achieving nonrecognition treatment: a taxpayer must hold both the relinquished property and the replacement property either for productive use in a trade or business or for investment.²¹² Current law, thus, uses an intent-based holding requirement; that is, at the time of the exchange, the taxpayer must have intended to hold the exchanged properties for either a business or investment purpose. There are, of course, other options. The like kind rule could require that the taxpayer hold the relinquished and replacement properties for business use or investment for a specified period of time.²¹³ A third possibility would be to not have a holding requirement; the involuntary conversion rule does not require that the properties be held for certain uses, thus, suggesting that a holding requirement is not a *sine qua non* for nonrecognition treatment. This section examines which of these options would best promote fundamental tax policies.²¹⁴

212. See I.R.C. § 1031(a)(1) (2000). It is permissible for the relinquished property to be held for investment and for the replacement property to be held for business use, or vice versa. See Treas. Reg. § 1.1031(a)-1(a)(1) (2001).

213. See H. R. 3299, 101st Cong. (1989) (bill, which was not enacted into law) calling for several amendments to the like kind rule, including a provision requiring taxpayers (i) to have held the relinquished property for either business use or investment for the one-year period ending on the date of the exchange and (ii) to hold the replacement property for either business use or investment for the one-year period beginning on the date of the exchange); see also STAFF OF THE JOINT COMM. ON TAXATION; *supra* note 12, at 305 (recommending that the relinquished and replacement properties be held for either business use or investment for a specified period of time, with the period of use by the taxpayer's transferor counting toward this requirement in certain circumstances).

214. Aside from possibly being supported by fundamental tax policies, the policy rationale for the holding requirement is not completely clear. The legislative history to the Internal Revenue Act of 1921, which contained the first like kind statute, does not expressly discuss the reasons for the holding requirement. Nevertheless, the holding requirement appears to relate to a congressional purpose of encouraging economically desirable transactions. See Jensen, *supra* note 10, at 90 (speculating that this is the reason for the holding requirement); cf. William D. Popkin, *The Deep Structure of Capital Gains*, 33 CASE W. RES. L. REV. 153, 158 (1983) (concluding based on the legislative history of the 1921 Act that this economic purpose was the reason for the enactment of the like kind provision); Trent, *supra* note 57, at 367 (viewing Section 1031 as implementing a pro-investment policy). As noted earlier, I do not view targeted measures aimed at promoting economic growth as advancing fundamental tax policies. See *supra* note 17. Consequently, this section will analyze the holding requirement in light of the efficiency norm aimed at minimizing excess burden, the fundamental policy assumed to support the like kind rule, as well as administrability.

Before proceeding, it would aid the analysis to divide the application of the holding requirement into several categories of situations. The holding requirement can prevent nonrecognition treatment under the like kind rule in two general types of situations: (i) where property involved in the exchange is received shortly before, or transferred shortly after, the exchange, and (ii) where property involved in the exchange is held for personal purposes either at the time of the exchange, or shortly before or after the exchange. The first situational category can be further divided into three subcategories: (i) situations where property involved in the exchange is involved in another nonrecognition transaction prior or subsequent to the exchange, (ii) situations where property involved in the exchange is either gifted to the taxpayer before the exchange or gifted by the taxpayer after the exchange, and (iii) situations where property involved in the exchange is involved in a taxable transaction prior or subsequent to the exchange. Because the policy analysis of these situations may differ, and because the holding requirement could be retained for some categories but for not others, this section will analyze each of the four situational categories separately in determining which of the holding requirement options would best promote fundamental tax policies.

1. Prior or Subsequent Nonrecognition Transactions

Under current law, a taxpayer may not satisfy the holding requirement when property involved in an exchange is received shortly before, or transferred shortly after, the exchange by the taxpayer in a nonrecognition transaction. For example, the IRS has ruled that the holding requirement is not satisfied where a taxpayer contributes the exchanged property to a controlled corporation immediately after the exchange.²¹⁵ Similarly, the IRS has ruled that the taxpayer fails to satisfy the holding requirement where the exchanged property was received immediately prior to the exchange as part of a tax-free liquidation of a wholly-owned corporation.²¹⁶ On the other hand, the courts have held that a taxpayer's immediate contribution of property received in an exchange to a general partnership did not violate the holding requirement.²¹⁷ The courts have also permitted nonrecognition treatment under the like kind rule where taxpayers engaged in an exchange of like kind property either shortly before or after tax-free liquidations under old Section 333.²¹⁸ Similarly, the Tax Court has held that

215. See Rev. Rul. 75-292, 1975-2 C.B. 333.

216. See Rev. Rul. 77-337, 1977-2 C.B. 305.

217. See *Magneson v. Commissioner*, 753 F.2d 1490 (9th Cir. 1985), *aff'g* 81 T.C. 767 (1983).

218. See *Bolker v. Commissioner*, 760 F.2d 1039 (9th Cir. 1985), *aff'g* 81 T.C. 782 (1983) (liquidation before like kind exchange); *Maloney v. Commissioner*, 93 T.C. 89

former partners satisfied the holding requirement where they exchanged property that was distributed to them by their just-terminated partnership.²¹⁹ The IRS has ruled that an exchange did not violate the holding requirement where it was followed shortly by the taxpayer's liquidation into its parent organization and the parent's merger into another corporation.²²⁰

The efficiency rationale for the like kind rule suggests that the provision should not contain a holding requirement (whether intent based or specific period based) that prohibits prior or subsequent nonrecognition transactions. According to the efficiency rationale, a taxpayer who would be denied like kind nonrecognition treatment if she were to couple a like kind transaction with a corporate or partnership contribution may well forego the like kind transaction and simply contribute the originally held property to the corporation or the partnership; if, as it is assumed, taxing a like kind transaction would result in efficiency costs by deterring relatively tax-elastic transactions, the same efficiency consequences would appear to arise when the like kind transaction is a precursor to a corporate or partnership contribution, provided that the like kind transaction is not an essential step. Where a taxpayer cannot forgo the like kind component because it is critical to the contemplated series of transactions, the application of the holding requirement in this situation would apparently result in efficiency costs by causing the taxpayer to alter her behavior in other ways in order to avoid current taxation.²²¹ One possibility is that the taxpayer could forgo the desired contribution in favor of leasing the property to the particular entity.²²² Alternatively, the taxpayer may simply hold onto the property for a

(1989) (liquidation after like kind exchange).

219. See *Mason v. Commissioner*, T.C. Memo 1988-273.

220. See Priv. Ltr. Rul. 98-50-001 (Dec. 11, 1998).

221. See STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 12, at 305 (recommending the effective elimination of the holding requirement with regard to prior or subsequent nonrecognition transactions; one reason for doing so is that taxpayers would not have to avoid engaging in nonrecognition transactions solely to meet the holding requirement, thus, permitting taxpayers to structure their business or investment activities in the most efficient manner).

222. Professor Shaviro points out that a contribution to a partnership is likely to be more tax-elastic than an outright sale because a tax on such a contribution could easily be avoided by instead leasing the property to the partnership. See Shaviro, *supra* note 17, at 49. Professor Shaviro notes that a lease is quite likely to be feasible for persons who are willing to form a partnership, given that they are willing to enter into an ongoing contractual relationship. *Id.* Consequently, if a related like kind transaction and partnership contribution were subject to tax because of the holding requirement, a taxpayer may well lease the property to the partnership in lieu of a contribution. Likewise, Professor Shaviro points out that taxing contributions to corporations may encourage alternative arrangements such as leasing, although possibly not to the same degree because of the important non-tax advantage of limited liability. *Id.* at 52.

long enough period following the exchange before making the entity contribution,²²³ or lease the property to the entity while waiting. Similarly, if the holding requirement were to prevent nonrecognition treatment in these situations, a taxpayer planning a partnership distribution to be followed by a like kind transaction may well seek alternative arrangements,²²⁴ such as forgoing the like kind transaction, having the partnership enter into a like kind transaction followed by a lease of the replacement property to the taxpayer,²²⁵ or distributing the original property to the taxpayer and waiting long enough before executing the like kind transaction. Further, a taxpayer contemplating a like kind transaction and a subsequent parent-subsidiary liquidation may well forgo the liquidation if the holding requirement would cause current taxation, as such a liquidation is for the most part a mere change in form.²²⁶ Thus, it would appear that for these situations only the "no holding requirement" option is consistent with the efficiency rationale; a prohibition on prior or subsequent nonrecognition transactions apparently produces efficiency costs by deterring (or delaying) either the like kind transaction or the entity contribution or distribution.

In addition, tax administration considerations indicate that not applying the holding requirement in this situation is the preferred approach. In this regard, the worst of the options is the use of an intent-based holding requirement that can disqualify like kind transactions that are coupled with nonrecognition transactions. This approach, which is used under current law, necessitates a fact-intensive analysis of the particular circumstances surrounding the transactions, and like other such approaches, results in uncertainty, controversy, and a lack of predictability for taxpayers.²²⁷ The complexity of the current law in this area is compounded by the uncertain legal standards; the courts and the IRS have

223. Cf. Shaviro, *supra* note 17, at 47 (pointing out that the wash sale rule may result in efficiency costs to the extent that taxpayers alter their transactions to avoid the rule, by waiting more than thirty days to buy back loss stock where they otherwise would have repurchased the stock sooner); *infra* notes 253-62 and accompanying text (discussing the efficiency consequences of narrow rules with continuous frictions).

224. Cf. Lipton, *supra* note 178, at 81 (finding that there is no policy reason for denying Section 1031 treatment where property distributed by a partnership is exchanged for like kind property, given that the taxpayer's economic position has not changed).

225. Cf. Shaviro, *supra* note 17, at 49 (noting that if partnership distributions were subject to tax, they may avoid the tax through alternative arrangements such as using leases).

226. Cf. Shaviro, *supra* note 17, at 55 (pointing out that currently taxing the liquidation of a controlled subsidiary would probably deter such transactions in many cases given that they are sufficiently a mere change in form).

227. See Levine, *supra* note 83, at A-3, A-21 (noting that it is uncertain how long the relinquished and replacement properties must be held by the taxpayer to satisfy the holding requirement).

allowed certain types of nonrecognition transactions, but not others, to be coupled with like kind exchanges.²²⁸ Nevertheless, even with clear legal standards, an intent test presents administrative difficulties and results in costly tax planning. Partly for these reasons, the staff of the Joint Committee on Taxation has recommended that the occurrence of prior or subsequent nonrecognition transactions should not affect whether the holding requirement is met.²²⁹

The use of a specific period-based holding requirement for these situations would also result in complexity. As is the case with other specific holding period requirements,²³⁰ this approach would appear to require rules that suspend the holding period for any periods that a taxpayer's risk of loss with respect to the property is substantially diminished by arrangements such as holding a put on the exchanged property, a short sale, or other similar transactions;²³¹ otherwise, the holding requirement would appear to lack substance and be easily avoidable. As a consequence, while the use of a specific holding period requirement would avoid the uncertainty regarding how long the exchanged properties must be held, the apparent need to have risk of loss rules introduces intricacy, as well as uncertainty given that rules should be open-ended to a degree. In addition, there would still be a significant amount of tax planning with such an approach, as taxpayers will no doubt seek alternative arrangements to avoid the recognition of gain,²³² and probably attempt to devise strategies aimed at minimizing the risk of loss while avoiding the rules which would suspend the holding period.

The best option administratively would be to allow like kind nonrecognition treatment regardless of whether there is a prior or subsequent nonrecognition transaction. This approach would avoid the uncertainty and intricacy of the other options, as well as reduce the amount of tax planning in these situations. Consequently, because this approach appears to be also supported by the efficiency rationale, this Article recommends that qualification under the like kind rule be unaffected by prior or subsequent nonrecognition transactions involving the relinquished or replacement property.

228. See *supra* notes 215-20 and accompanying text.

229. See STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 12, 305.

230. See, e.g., I.R.C. § 1031(g) (2000) (risk of loss rules that apply in connection with the specific holding period used under the like kind related party rule); *id.* § 453(e)(2) (risk of loss rules that apply in connection with the specific holding period used under the installment method related party rule).

231. Indeed, the 1989 proposal to use a specific period-based holding requirement under the like kind rule incorporated the risk of loss rules under the like kind related party rule. See H.R. REP. No. 101-247, at 1342 (1989).

232. See *supra* notes 221-26 and accompanying text.

2. Prior or Subsequent Gifts

Under current law, a taxpayer may not satisfy the holding requirement when the property involved in the exchange is either gifted to the taxpayer shortly before the exchange or gifted by the taxpayer shortly after the exchange. For example, the Tax Court has held that an exchange did not qualify under the like kind rule where the taxpayer gifted the replacement properties, which were two residences, to her children seven months after the exchange, and during the seven month period the children lived in, and made improvements to, the residences. The court concluded that the taxpayer acquired the replacement properties with the intention of making the gifts, thus, failing to satisfy the holding requirement.²³³

The policy analysis of the holding requirement for the gift situation is similar to the analysis for the situation involving related nonrecognition transactions. With regard to efficiency, a holding requirement that prohibits prior or subsequent gifts would appear to result in efficiency costs. With such a holding requirement, a taxpayer contemplating a like kind transaction and subsequent gift would likely change her behavior, rather than suffer current income taxation, by either foregoing the like kind transaction, gifting other property instead,²³⁴ or waiting long enough before making the gift. For the reasons expressed earlier,²³⁵ the best option administratively is not to disqualify a like kind transaction because of the occurrence of a prior or subsequent gift of the relinquished or replacement property. Consequently, this Article recommends the use of this approach.

3. Prior or Subsequent Taxable Transactions

Under current law, a taxpayer may be denied like kind nonrecognition treatment under the holding requirement when the property involved in the exchange is received shortly before, or is transferred (or intended to be transferred) shortly after, the exchange by the taxpayer in a taxable sale or exchange; in these circumstances, the courts and the IRS may determine that the exchanged property was not held for a business or investment purpose, but

233. *Click v. Commissioner*, 78 T.C. 225 (1982), *aff'd in an unpub. opin.* (4th Cir. 1982). On the other hand, the Tax Court upheld a qualifying like kind exchange when the taxpayer gifted the replacement property to his son nine months after the exchange. *See Wagensen v. Commissioner*, 74 T.C. 653 (1980).

234. *See Shaviro, supra* note 17, at 41 (noting this planning response as one of the reasons why a rule imposing current tax on gifts of appreciated property might be questionable on efficiency grounds).

235. *See supra* notes 227-32 and accompanying text.

instead for the purpose of disposing of the property.²³⁶ Importantly, however, the tax consequences stemming from the denial of like kind treatment in these circumstances are generally quite minimal. This is because where a taxpayer acquires the relinquished property in a taxable transaction shortly before the exchange, her basis in the property would likely be approximately equal to the fair market value of the property at the time of the exchange; consequently, there should be little realized gain or loss on the exchange.²³⁷ Similarly, where the taxpayer disposes of the replacement property in a taxable transaction shortly after the exchange, her amount realized on the transaction would likely be approximately equal to the fair market value of the property at the time of the exchange; therefore, any gain or loss that would not be recognized on the exchange would likely be recognized anyway on the subsequent taxable transaction. To be sure, denying like kind treatment in situations where a taxpayer intends to sell the replacement property would have significant tax consequences if the sale does not occur for a number of years. It would appear unlikely that the courts or the IRS, however, would find such an intention in the absence of a subsequent sale, although there are a few reported cases where this has occurred;²³⁸ and, where an intention to sell the replacement property is found to exist despite there being no sale by the time of the determination, it would seem likely that a sale would occur in the near future, thus, minimizing the tax benefits resulting from according nonrecognition treatment to the like kind transaction. In light of the likely minimal tax consequences, it does not seem to be worth the effort to administer a prohibition on prior or subsequent taxable transactions. Consequently, this Article recommends that qualification under the like kind rule be unaffected by either the occurrence of a prior purchase of the relinquished property or subsequent sale of the replacement property, or an intention to sell the replacement property.²³⁹

236. See, e.g., Rev. Rul. 77-297, 1977-2 C.B. 304.

237. See *id.*

238. See *Regals Realty Co. v. Commissioner*, 127 F.2d 931 (2d Cir. 1942); *Black v. Commissioner*, 35 T.C. 90 (1960); *Land Dynamics v. Commissioner*, 37 T.C. Memo 1978-259.

239. Nonetheless, the exclusion for inventory property and the like would prevent qualification under the like kind rule for situations where the relinquished property is held primarily for sale. See *id.* § 1031(a)(2)(A) (2000). (As noted earlier, this Article is not altering the type of property excluded from the coverage of the like kind rule. See *supra* note 83 and accompanying text.) Furthermore, while the language of the Section 1031(a)(2)(A) exclusion would seem to suggest otherwise, some courts and commentators appear to read the Section 1031(a)(2)(A) exclusion as applying to the replacement property as well. See *Black v. Commissioner*, 35 T.C. 90 (1960); *Land Dynamics v. Commissioner*, 37 T.C. Memo 1978-259; *Woodbury v. Commissioner*, 49 T.C. 180, 197 (1967); *Levine, supra* note 83, at A-29. Consequently, if this view is

4. Personal Use Property

Under current law, a transaction does not qualify under the like kind rule where the taxpayer holds either the relinquished property or the replacement property for personal purposes. For the most part, the restriction for personal use property affects personal residences; except for collectibles, other types of personal use property rarely appreciate in value, and with the apparently narrow like kind standard for collectibles,²⁴⁰ the personal use restriction probably has little effect on these items.²⁴¹ Thus, the primary effect of the holding requirement in this situation is to deny like kind treatment where a taxpayer exchanges a personal residence for other real estate or vice versa. Because the holding requirement is concerned with a taxpayer's intent at the time of the exchange, realty that is recently converted from or to personal residence status can be disqualified as well.

Personal residences include principal residences as well as other residences, or what may be referred to as vacation homes. With regard to principal residences, however, the exclusion of gain under Section 121 lessens the impact of the holding requirement. This provision allows a taxpayer to exclude \$250,000 (or \$500,000, if married filing jointly) of gain from the sale of a principal residence, provided that the taxpayer used the property as her principal residence for two of the previous five years.²⁴² Consequently, assuming that the Section 121 holding period is satisfied, a taxpayer disposing of a principal residence would only be concerned with qualifying under the like kind rule in situations where there is more than \$250,000 (or \$500,000, if the taxpayer is

followed, an intention to sell the replacement property may still disqualify the transaction for Section 1031 treatment despite my recommendation to not apply the holding requirement in this context.

240. Cf. Priv. Ltr. Rul. 81-27-089 (Apr. 10, 1981) (dealing with artwork).

241. In any event, since the desire to dispose of a collectible is not likely to be motivated by important personal or business objectives, the disposition of a collectible followed by a related acquisition of a similar collectible may well be deterred in the absence of nonrecognition treatment; consequently, the efficiency rationale for the like kind rule would seem to support the rule's application to collectibles. As discussed below, this may not be the case for personal residences. See *infra* notes 245-65 and accompanying text.

242. I.R.C. § 121 (2000). The provision waives the two-year holding period requirement (with a reduced gain exclusion limitation) for dispositions of principal residences resulting from a change in the place of employment or the health of the taxpayer. *Id.* § 121(c).

married filing jointly) of realized gain on the disposition;²⁴³ I shall refer to such situations as dispositions of a “mega” residence.²⁴⁴

The efficiency consequences of denying like kind treatment to the disposition of a mega residence appear to be uncertain.²⁴⁵ On the one hand, a taxpayer desiring to change principal residences may well be motivated by important personal or business objectives, such as the need for a larger home due to family circumstances or the need to relocate because of a change in the place of employment; consequently, despite the similarities of the properties involved, such a transaction may well have substantial nontax significance and, thus, may not be deterred by current taxation.²⁴⁶ As a result, applying the holding requirement to deny like kind nonrecognition treatment in this situation may not produce efficiency costs at Time Two. On the other hand, wealthier taxpayers (who would typically be the type of taxpayer disposing of a mega residence)²⁴⁷ may base their decision to change principal residences on more discretionary reasons, such as a change of scenery or desire to have more luxury, which may make the disposition more tax-elastic.

Perhaps of greater significance, a wealthier taxpayer in particular (because of greater sophistication or greater access to tax advisers), may attempt to convert her mega residence into investment real estate by renting it out for a sufficient period of time before the disposition.²⁴⁸ The former mega residence could then be exchanged for business or investment real estate in a qualifying like kind transaction. The taxpayer, after a sufficient period of time, may then

243. Even in these situations, taxpayers may be unconcerned with satisfying the like kind rule unless the amount of realized gain significantly exceeds the excludable amount under Section 121.

244. I acknowledge Professor Annette Nellen and Mr. Ron Platner for devising this label for principal residences that exceed Section 121's dollar limitations. See Annette Nellen and Ron Platner, *Disposition of a Principal Residence after TRA '97: Perspective, Planning, and Problems*, 25 J. REAL EST. TAX'N 319 (1998).

245. The analysis in this subsection assumes that Section 121 will continue to be a feature of the tax law.

246. See Shaviro, *supra* note 17, at 46.

247. In this regard, it is reported that the percentage of home sales with realized gains exceeding \$500,000 is less than one percent. See CHIRELSTEIN, *supra* note 71 at 341.

248. See Nellen and Platner, *supra* note 244, at 325-30 (discussing strategies to convert a mega residence to investment property for purposes of qualifying under Section 1031; stating their belief that the bona fide rental of a mega residence for at least one year should be sufficient to convert the residence into qualifying property for purposes of the like kind rule); cf. Priv. Ltr. Rul. 84-29-039 (April 17, 1984) (stating that a rental period of two years is sufficient to convert a residence to investment property for purposes of Section 1031); Hamill, *supra* note 176, at 719 (pointing out that temporary rentals of at least a year are advised to establish investment motive).

be able to convert the replacement property into her new principal residence, although the step transaction doctrine may prevent this strategy;²⁴⁹ alternatively, the taxpayer may be able to use borrowings or other funds to acquire her new principal residence. A taxpayer who wants to dispose of a mega residence and acquire a smaller principal residence may also have an avenue for achieving current tax-free treatment. Specifically, it may be possible to first convert the mega residence into qualifying Section 1031 property by employing a temporary rental strategy and then exchange the property for a new principal residence and qualifying like kind replacement property (e.g., rental real estate) in a tax-free transaction.²⁵⁰ While the new principal residence would be treated as boot for purposes of recognizing gain under the like kind rule (because it would not be qualifying Section 1031 property), the taxpayer may be able to exclude the gain on the mega residence under Section 121 (up to the \$250,000 or \$500,000 limitation).²⁵¹ These possibilities suggest that the denial of like kind treatment in this situation may well result in tax-induced behavioral changes and, thus, efficiency costs at Time Two.²⁵²

249. See Nellen and Platner, *supra* note 244, at 328, 331 (noting possible conversion of the replacement property into a principal residence and pointing out potential step transaction doctrine obstacle).

250. *Cf. id.* at 326-28 (suggesting similar techniques for disposing of mega residences).

251. See *id.* at 326 (concluding that there appear to be no policy reasons against the simultaneous application of Sections 1031 and 121; stating that official guidance is needed in this area). Indeed, proposed regulations under Section 121 effectively apply this treatment to involuntary conversions by reducing the amount realized on the conversion by the amount of gain excluded under Section 121. See Prop. Treas. Reg. § 1.121-4(d), Fed. Reg. 60136, 60140 (Oct. 10, 2000). Thus, under these proposed regulations, the cash that a taxpayer effectively squeezes out of an involuntary conversion and subsequent replacement, which normally would bring about the recognition of realized gain (to the extent of the cash), will not result in includable gain to the extent of the Section 121 exclusion.

252. Where a taxpayer's primary goal is not to change principal residences, but instead to shift the amounts invested in a mega residence to an investment in income producing real estate, the Time Two costs resulting from the application of the holding requirement appear to be greater. Because a disposition of the mega residence in this situation would not be motivated by important personal or business reasons, the disposition would more likely be deterred (as compared to the change of principal residence situation) in the absence of like kind nonrecognition treatment. Furthermore, in this situation the taxpayer would only have to convert the relinquished property into investment realty in order to achieve both her nontax objective as well as qualifying for like kind treatment, thus, suggesting an even greater possibility that the taxpayer would employ a temporary rental strategy.

The application of the holding requirement to mega residences and the ability of taxpayers to satisfy it by employing temporary rental strategies is an example of what Professor Schizer describes as a narrow rule with a continuous friction.²⁵³ According to Schizer, a friction is a constraint on tax planning that is external to the tax law.²⁵⁴ As he points out, a narrow rule that prevents a tax benefit is less likely to be effective where frictions are continuous, that is, where a taxpayer can wait a little longer or take on a little more risk in order to obtain the desired tax treatment.²⁵⁵ The use of a narrow rule in these situations may result in socially wasteful tax-motivated transactions while not preventing taxpayers from qualifying for the sought after tax benefit.²⁵⁶ Consistent with Professor Schizer's analysis, the application of the holding requirement to dispositions of mega residences may well result in temporary rentals involving the residences followed by like kind transactions, as opposed to taxable dispositions of the mega residences, thus, possibly producing inefficient, tax-motivated transactions.

Where there are continuous frictions, doing nothing may be better than having an ineffective narrow rule.²⁵⁷ There is, however, another option: a broader response, if feasible, may be appropriate to limit the availability of the tax benefit at issue.²⁵⁸ Specifically, to curb tax-motivated rentals of mega residences, the like kind rule could provide that a taxpayer would need to use a former residence for at least several years (*e.g.*, five years) in an income producing activity in order for the property to qualify for nonrecognition treatment under Section 1031. While a taxpayer can always rent out the former residence a little longer, the cumulative effect of this continuous friction may deter most taxpayers from employing temporary rental strategies to satisfy the like kind rule.²⁵⁹ Nonetheless, such a lengthy, specific period holding requirement may still result in efficiency costs at Time Two. As mentioned earlier, because the disposition of a mega residence may be discretionary, rather

253. See David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312, 1327-28 (2001).

254. See *id.* at 1315 (stating that the term is being borrowed from the economics literature).

255. See *id.* at 1326-27. In contrast, a narrow rule can be effective where frictions are discontinuous; that is, end runs around a rule are unlikely where the taxpayer would experience a large and unavoidable utility cost that exceeds the tax benefit involved. See *id.* at 1325.

256. See *id.* at 1320.

257. See *id.* at 1320-21.

258. See *id.* at 1321, 1326.

259. Cf. *id.* at 1326 (pointing out that in order for the cumulative effect of a continuous friction to serve as an adequate deterrent, a rule preventing a tax benefit must be broader).

than compelled by a taxpayer's circumstances, the prospect of current taxation may well cause the taxpayer to forgo changing residences.²⁶⁰ Furthermore, even with a lengthy holding requirement, some taxpayers would still engage in temporary rentals to satisfy the requirement; and for these taxpayers, the efficiency costs would be larger (vis-à-vis a shorter holding requirement), given that there would be a greater amount of tax-induced behavior (*i.e.*, longer temporary rentals).²⁶¹ Probably of more significance, a lengthy holding requirement may result in the denial of like kind treatment in many situations where the conversion of the former residence to an income producing use was not a part of a plan to ultimately engage in a like kind transaction.²⁶² Where a taxpayer's decision to dispose of a former residence and acquire like kind replacement property occurs *after* the property has been converted to rental property, the intended disposition would appear to be relatively tax-elastic; unlike the disposition of a principal residence, important personal or business reasons would likely not be a factor in the decision to dispose of property that, at the time of the decision, is already being used in an income-producing capacity. Consequently, with a lengthy holding requirement, taxpayers in these situations may well either forgo the disposition or continue to rent out the property in order to satisfy the holding requirement, thus, resulting in possible Time Two efficiency costs for these taxpayers.

In addition, the denial of like kind treatment on the disposition of a mega residence may result in Time Two efficiency costs by making it more likely that taxpayers may engage in a tax-induced sale of their principal residence. That is, with the dollar limitations on the excludable gain under Section 121, taxpayers have an incentive to dispose of their principal residences when the amount of unrealized gain on the residence reaches \$250,000 (or \$500,000, if the taxpayer

260. See *supra* note 247 and accompanying text.

261. See David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1669-70 (1999) (pointing out that rules that reduce the number of taxpayers who engage in tax-induced behavior may actually result in an increase in overall efficiency costs because of greater efficiency costs for those taxpayers who continue to alter their behavior). Of course, it would be possible to completely eliminate temporary rental strategies by crafting a rule providing that a former residence is ineligible for like kind nonrecognition treatment. Such an approach, however, would significantly increase the number of situations where like kind nonrecognition treatment would be denied even though the decision to dispose of the former residence and acquire like kind replacement property occurred after the conversion to rental property—thus, depriving many relatively tax-elastic transactions of nonrecognition treatment. See *infra* note 262 and accompanying text.

262. Cf. Schizer, *supra* note 251, at 1321 (pointing out that a downside to using broad rules is that they burden good transactions as well as bad).

is married filing jointly).²⁶³ With the availability of like kind treatment for mega residences, taxpayers may be less likely to dispose of their residences when the dollar limitation is reached, given that there would be another avenue for achieving current tax-free treatment upon the disposition of their residences.

Balanced against the potential Time Two efficiency costs produced by the holding requirement are possible efficiency benefits. That is, applying the holding requirement to the disposition of a mega residence and, thus, disallowing nonrecognition treatment may result in Time One benefits by increasing the expected tax on such property. There may be Time Two benefits as well, in that with no opportunity for nonrecognition treatment on the disposition of a mega residence, taxpayers will not have a tax incentive to acquire real property as replacement property as opposed to other investment or business assets.²⁶⁴ Of course, this Article assumes that taxing transactions that result in an insignificant change in a taxpayer's position produces Time Two efficiency costs that exceed the Time One and Time Two efficiency benefits;²⁶⁵ however, the efficiency costs resulting from disallowing nonrecognition treatment on the disposition of a mega residence, even if present, may not be significant enough to outweigh the resulting efficiency benefits, given the important personal and business reasons for going forward with the sale (and forgoing a temporary rental strategy) despite current taxation. Consequently, the efficiency effects of denying like kind nonrecognition treatment to the disposition of a mega residence appear to be quite uncertain.

For other situations involving residences, a stronger case can be made that denying like kind nonrecognition treatment produces efficiency costs. These situations include vacation homes for other vacation homes, vacation homes for business or investment realty, business or investment realty for vacation homes, and business or investment realty for principal residences. Given that these transactions are not as likely to be motivated by important personal or business reasons, as compared to the dispositions of principal residences, they would appear to be more tax-elastic than the dispositions of mega residences. Consequently, the application of the holding requirement in these situations may well deter the dispositions, thus, resulting in efficiency costs at Time Two. Alternatively, as with the situations involving mega residences, a taxpayer may attempt to qualify the relinquished property or the replacement property for Section 1031 treatment by employing a temporary rental strategy.

263. See Nellen and Platner, *supra* note 244, at 332-33.

264. Cf. H.R. REP. NO. 105-148, at 347, 1997-4 C.B. 669 (noting as a reason for the repeal of Section 1034's rollover treatment on the sale of a principal residence the fact that the provision encouraged some taxpayers to purchase larger and more expensive homes than they otherwise would in order to avoid a current tax liability).

265. See *supra* notes 78-79 and accompanying text.

With limited guidance provided by efficiency analysis, tax administration concerns should determine which holding requirement option to use for this situational category. As with respect to the other categories, not applying the holding requirement to this situation has administrative advantages over the alternative approaches for implementing a holding requirement.²⁶⁶ Additionally, not applying the holding requirement in this situational category would avoid the current administrative difficulties of applying the like kind rule to the disposition of properties with both personal and business/investment uses.²⁶⁷ Consequently, this Article suggests that qualification under the like kind rule be determined without regard to whether the relinquished or replacement property is held for personal purposes.²⁶⁸ In light of the recommendations for the other situational categories, this would result in the complete elimination of the holding requirement.

E. Controlling Stock Interests As Eligible Replacement Property

Under current law, a taxpayer can achieve nonrecognition treatment on an involuntary conversion by purchasing a controlling stock interest in a corporation holding eligible replacement property, in addition to a direct acquisition of such property.²⁶⁹ For like kind exchanges, however, only direct acquisitions of eligible replacement property are permitted.²⁷⁰ Issues are, therefore, raised as to whether fundamental tax policies support allowing indirect

266. See *supra* notes 227-32 and accompanying text.

267. See Kneave Riggall, *Dual Use of Property Does Not Bar Nonrecognition*, 54 TAX'NFOR ACCT. 196, 196-99 (1995) (revealing complications of applying Section 1031 to dual use property).

268. Despite this suggested change, it is worth considering an alternative that would modify the holding requirement as it applies to personal use assets: eliminate the holding requirement generally, but deny like kind nonrecognition treatment in situations where the Section 121 exclusion applies to the disposition of the relinquished property, that is, where the taxpayer owned and used the relinquished property as her principal residence for two of the previous five years. This approach would deny like kind nonrecognition treatment in the circumstance involving personal use property where the efficiency case for nonrecognition treatment appears to be the weakest; and, because such a principal residence determination needs to be made in any event for purposes of the Section 121 exclusion, the administrative costs of this approach may not be significant, even though they would likely exceed the administrative costs associated with the no holding requirement option for the personal use situation. Moreover, vertical equity notions may provide additional support for denying like kind nonrecognition treatment to dispositions of mega residences.

269. See I.R.C. § 1033(a)(2) (2000).

270. See *id.* § 1031(a).

acquisitions of eligible replacement property for purposes of the like kind and involuntary conversion rules.

Allowing controlling stock interests to satisfy the replacement requirement for involuntary conversions appears to be supported by considerations of horizontal equity and substance over form. A taxpayer holding property could contribute it to a corporation in exchange for a controlling stock interest and achieve nonrecognition treatment.²⁷¹ Given this, the perceptual horizontal equity basis for the involuntary conversion rule suggests that nonrecognition treatment should likewise be accorded a taxpayer who involuntarily disposes of property, acquires insignificantly different property, and then contributes the second property to a corporation for a controlling stock interest, and the authorities have so held.²⁷² Substance over form considerations appear to suggest that the tax consequences should not be any different if the involuntary converter instead acquired a controlling stock interest in a corporation holding the eligible replacement property; in both cases the net result is the same, given that the taxpayer is left holding a controlling stock interest in a corporation that holds eligible replacement property. Similar considerations apply in the context of like kind transactions. With the recommended elimination of the holding requirement,²⁷³ a taxpayer would be permitted under the like kind rule to dispose of property, acquire like kind replacement property, and then contribute the replacement property to a corporation in exchange for a controlling stock interest. Again, substance over form considerations appear to suggest that the same tax treatment should apply to the acquisition of a controlling stock interest in a corporation holding the like kind replacement property.

Furthermore, for both like kind transactions and involuntary conversions, a plausible case can be made for extending the indirect replacement rule to include interests in partnerships holding eligible replacement property. Under both the current law and the recommendations made in this Article, taxpayers involved in like kind transactions and involuntary conversions may contribute eligible replacement property to partnerships without losing nonrecognition treatment on the dispositions.²⁷⁴ Consequently, substance over form notions appear to also provide a basis for treating the acquisition of an interest in a partnership that holds eligible replacement property as allowing for nonrecognition treatment.²⁷⁵

271. *See id.* § 351(a).

272. *See, e.g.*, Rev. Rul. 84-29, 1984-1 C.B. 181.

273. *See supra* Part V.D.

274. *See supra* Part V.D. (discussion of the like kind rule); Priv. Ltr. Rul. 90-20-013 (May 18, 1990) (involuntary conversion rule, where contributor's thirty-nine percent equity interest in the partnership was determined to be adequate control so as to qualify under Section 1033).

275. In light of the current statutory language, however, the IRS and the courts

An examination of efficiency considerations, however, suggests that the substance over form basis for allowing indirect acquisitions may be weaker than it first appears. At its core, allowing substance to dictate over form appears to be founded on notions of efficiency. Where the form rather than the substance of a transaction controls for tax purposes, taxpayers may be induced by the tax consequences to follow a certain path to a desired end, even when that path may result in additional transaction costs or other nontax disadvantages.²⁷⁶ Nevertheless, while subjecting different routes to disparate tax treatment affects taxpayer behavior, this effect may be relatively insignificant when compared to other behavioral effects caused by the tax system, such as holding onto an asset that, tax aside, the taxpayer desires to sell, or investing in an asset, that tax aside, the taxpayer would not acquire; as long as at least one tax-free route remains open, a taxpayer should still generally be able to achieve her desired end. Thus, even though a rule preventing indirect acquisitions of replacement property may cause taxpayers to incur additional ancillary costs, they should generally be able to achieve their main objective by directly acquiring the replacement property and contributing it to a corporation or partnership.²⁷⁷

have generally not allowed for nonrecognition treatment in these circumstances under either the like kind rule or the involuntary conversion rule. *See, e.g.*, Rev. Rul. 57-154, 1957-1 C.B. 262.

276. Professor Shaviro points out that the existence of alternative routes with different tax consequences for moving from one position to another can create high tax elasticity. *See* Shaviro, *supra* note 17, at 35.

277. In addition, the controlling stock interest rule, as it currently exists under the involuntary conversion rule, contains limitations that may curtail its usefulness as an alternative to a direct acquisition of replacement property followed by a contribution to a corporation. First, in order to prevent taxpayers from achieving nonrecognition treatment when they have effectively re-invested only a small portion of the conversion proceeds in eligible replacement property, the courts and IRS require that the acquired corporation's assets consist principally of eligible replacement property. *See infra* note 278 and accompanying text. No such requirement applies to a direct acquisition followed by contribution to a corporation. Second, while it appears that an indirect acquisition of eligible replacement property is permitted only where the taxpayer acquires sole control of the corporation holding the replacement property (*see* Rev. Rul. 57-454, 1957-2 C.B. 526), a taxpayer using the direct acquisition followed by contribution route may be able to achieve nonrecognition treatment by acquiring control of the corporation either alone or together with other contributors who are a part of the same transaction. Control by a group of transferors can satisfy the control requirement under Section 351 for receiving nonrecognition treatment on the transfer to the corporation. I.R.C. § 351(a) (2000). Consequently, unless the direct replacement and corporate contribution are treated as a replacement by stock acquisition for purposes of Section 1033(a)(2)(A)'s control requirement under a step transaction analysis, a more liberal control requirement would apply to the direct acquisition/corporate contribution scenario. It should be noted, however, that in Rev. Rul. 84-29, 1984-1 C.B. 181 the IRS pointed out that the taxpayer

Balanced against the possibly insignificant efficiency gains that result from permitting indirect acquisitions of replacement property are the administrative costs required to implement such a rule. There are two major sources of administrative complexity associated with a rule permitting indirect acquisitions of replacement property. First, under the involuntary conversion rule, the courts and the IRS have required that the acquired corporation's assets consist principally of eligible replacement property.²⁷⁸ This requirement is necessary in order to prevent taxpayers from effectively re-investing only a small portion of the proceeds from the disposition in eligible replacement property. Like other similarly worded requirements under the tax law, this test lacks mathematical certainty, and also raises issues regarding asset valuations; consequently, this "principal" requirement has the potential for creating uncertainty as well as controversy between taxpayers and the IRS. In addition, the controlling stock interest rule applicable to involuntary conversions is accompanied by complex, special rules that adjust the acquired corporation's basis in its property.²⁷⁹ The rules requiring that a corporation adjust its internal basis are in addition to the standard basis rule that preserves in the replacement property, in this case the stock, the realized gain that went unrecognized on the involuntary conversion.²⁸⁰ The purpose of the internal basis rules is to prevent the taxpayer from having more aggregate depreciable basis (through the corporation) after the acquisition of replacement property than before the involuntary conversion.²⁸¹ While the internal basis rules are aimed at reducing, by the amount of the deferred gain, the corporation's basis in the eligible replacement property, the basis of other property (first, depreciable property other than eligible replacement property, then any other property) may need to be reduced where the amount of the deferred gain exceeds the corporation's original adjusted basis in the eligible replacement property.²⁸² Moreover, where the corporation holds more than one property that is eligible replacement property, the basis reduction needs to be allocated among these properties in proportion to their adjusted bases. With the recommended application of the generally more liberal like kind standard for

maintained control of the replacement assets after the transfer to the subsidiary corporation; this may suggest that the IRS views a direct replacement followed by a related corporate contribution as an effective stock acquisition replacement which is subject to Section 1033(a)(2)(A)'s control requirement.

278. See *Templeton v. Commissioner*, 66 T.C. 509, 514 (1976), *supplemented by* 67 T.C. 518, 518 (1976), *aff'd per curiam*, 573 F.2d 866 (4th Cir. 1978).

279. See I.R.C. § 1033(b)(3) (2000).

280. See *id.* § 1033(b)(2).

281. See H.R. REP. NO. 104-737, at 309 (1996), 1996-3 C.B. 1049-50.

282. See I.R.C. § 1033(b) (2000). This is subject to another limitation which prevents the aggregate adjusted basis in the corporation's assets from being reduced below the amount of the taxpayer's basis in the acquired stock.

both like kind transactions and involuntary conversions, a corporation may commonly hold more than one property that is eligible replacement property with respect to the property disposed of, thus, necessitating internal basis adjustments to multiple properties. The intricate mechanics of this provision are compounded by the depreciation consequences of the basis adjustments. If the indirect acquisition rule is extended to partnership interests, the complexities may be substantially greater, given the need to coordinate the internal basis rules with other special basis adjustments either required or available under Subchapter K.²⁸³ All of this no doubt causes increased compliance and tax planning efforts, with their attendant costs.

Based on the preceding analysis, two observations can be made regarding indirect acquisitions of replacement property. First, given the considerations for and against such treatment, it seems reasonably clear that the same approach should apply for both like kind transactions and involuntary conversions; the efficiency benefits/administrative costs tradeoff is as applicable to voluntary dispositions as it is to involuntary ones.²⁸⁴ Less clear, however, is whether or not to permit indirect acquisitions of replacement property. While adhering to substance over form principles in this context is likely to produce some efficiency benefits, these benefits may not justify the administrative costs involved in permitting indirect acquisitions of replacement property.²⁸⁵

283. See, e.g., *id.* § 754.

284. The indirect replacement rule for involuntary conversions was contained in the original version of the involuntary conversion provision enacted in the Revenue Act of 1921, which also included the original version of the like kind rule. Revenue Act of 1921, ch. 136, §§ 202(c)(1), 214(a)(12), 234(a)(14), 42 Stat. 227. The legislative history to the Revenue Act of 1921 provides no indication why indirect replacements were permitted for involuntary conversions but not for like kind exchanges. See H.R. REP. NO. 350, 67-350, pt. 1, at 8-10 (1921), *reprinted in* 1939-1 C.B. (pt. 2) 175-77; S. REP. NO. 67-275, pt. 1, at 11-12 (1921), *reprinted in* 1939-1 C.B. (pt. 2) 188-89, 191; H.R. CONF. NO. 67-486, at 5 (1921), *reprinted in* 1939-1 C.B. (pt.2) 215. A possible justification for this difference may be the need for greater flexibility in the acquisition form of replacements for involuntary conversions in light of the generally stricter standard with regard to eligible replacement property. Some support for this view can be found in Section 1033(g), which allows the use of the broad like kind test for condemnations of business or investment real property but does not permit indirect replacements to satisfy this standard. In any event, applying the same eligible replacement property standard for involuntary conversions and like kind transactions, as this Article recommends, would remove such a justification for treating these dispositions differently with respect to indirect replacements.

285. Of course, taxpayers wanting to avoid the internal basis complexities can always do so by engaging in direct acquisitions of replacement property. Thus, it can be argued that where taxpayers decide to acquire replacement property indirectly, the efficiency benefits resulting from taxpayers being able to employ their preferred

F. Generally Conforming the Like Kind and Involuntary Conversion Rules Should Result in Additional Administrative Benefits

The changes proposed by this Article would generally conform the rules applying to like kind transactions and involuntary conversions. This should produce additional administrative benefits by reducing the need to determine whether certain voluntary transactions constitute involuntary conversions. This section examines these aspects.

The primary goal of this Article is to suggest reforms with regard to the like kind and involuntary conversion rules in light of fundamental tax policies. Except with regard to the standard for determining eligible replacement property, this effort does not involve an explicit attempt to conform the two provisions. Nonetheless, a by-product of the recommendations made by this Article is the general conformance of the rules for like kind transactions and involuntary conversions. That is, with the suggested changes the two provisions would each contain the following features: the use of a modified like kind standard to determine eligible replacement property, the use of an express rollover mechanism, no requirement that the relinquished and replacement properties be held for business or investment purposes,²⁸⁶ and either permitting or not permitting the indirect acquisition of replacement property. In addition, with the suggestion to possibly shorten the replacement period for involuntary conversions, the replacement periods under the two provisions may be very similar. To be sure, some differences would remain, such as types of property excluded from coverage,²⁸⁷ the special rules for related party transactions,²⁸⁸ and rules dealing with special situations under the involuntary conversion provision.²⁸⁹ Yet, overall the two provisions would be very similar.

The general conformance of the rules for like kind transactions and involuntary conversions should result in additional administrative benefits by substantially reducing the need to distinguish between these two types of

acquisition form must outweigh the administrative costs involved. When one considers the government's costs in administering the internal basis rules, however, as well as in administering the principal corporate asset requirement, this may not be the case at all.

286. However, there would be a difference in this regard if like kind nonrecognition treatment is denied in situations where the Section 121 exclusion applies to the disposition of the relinquished property, an alternative approach that is worth considering. See *supra* note 268.

287. As noted earlier, Section 1031(a)(2) excludes inventory, financial assets, and the like from the application of the like kind rule. See *supra* note 4 and accompanying text. The involuntary conversion rule does not exclude any type of property from its coverage.

288. See I.R.C. §§ 1031(f), 1033(i) (2000).

289. See, e.g., *id.* § 1033(h) (dealing with presidentially declared disasters).

transactions. Under current law, disputes sometimes arise where taxpayers engage in voluntary transactions that arguably constitute involuntary conversions. One such situation is where a taxpayer voluntarily disposes of property that has been damaged. In cases of this type, the authorities seek to determine whether the disposition was essentially beyond a taxpayer's control, or whether the damaged property could have been repaired and, thus, the taxpayer's disposition was due to her preference for the selling the property rather than keeping it. The former situation would constitute an involuntary conversion, while the latter situation would not.²⁹⁰ The highly factual nature of this inquiry breeds uncertainty as well as controversy. Another situation is where a taxpayer voluntarily disposes of property that bears a functional relationship to other property that has been condemned. Here, the courts and the IRS have allowed involuntary conversion treatment for the voluntary disposition if the two properties were part of an "economic unit"²⁹¹ or "integrally related,"²⁹² fact-intensive standards that can present administrative difficulties. Problems can also arise where a taxpayer voluntarily disposes of property after receiving some indications that the property will be condemned. The issue in these cases is whether the circumstances amount to a threat of condemnation, a type of involuntary conversion.²⁹³ The use of substantially similar rules for like kind transactions and involuntary conversions should alleviate most of the controversies in these situations. This is because whether or not the situation is determined to be an involuntary conversion, the same basic requirements would apply for purposes of granting nonrecognition treatment to the disposition of property.²⁹⁴

290. See, e.g., *C.G. Willis, Inc. v. Commissioner*, 41 T.C. 468, 476 (1964), *aff'd per curiam*, 342 F.2d 996 (3d Cir. 1965); Rev. Rul. 78-377, 1978-2 C.B. 208 (1978); Priv. Ltr. Rul. 91-43-056 (Oct. 25, 1991); Priv. Ltr. Rul. 89-28-001 (July 14, 1989).

291. See *Masser v. Commissioner*, 30 T.C. 741, 747 (1958), *acq.*, 1959-2 C.B. 3.

292. See Priv. Ltr. Rul. 82-08-205 (Nov. 30, 1981).

293. See, e.g., *Balistreri v. Commissioner*, 38 T.C.M. 526 (1979); see Robert Kaplow, *Courts' Expansion of Threats of Condemnation Opens Door Wider to Section 1033 Benefits*, 51 J. TAX'N 368, 371 (1979) (discussing the pivotal factual issue of whether it was reasonable for the taxpayer to infer that the property would have been condemned if the property had not been sold to the private party).

294. If differences remain in the length of the replacement periods under the like kind and involuntary conversion rules, however, this would be a potential source of controversy in the situations described above, for example, where the replacement occurred within the involuntary conversion period but outside of the like kind period. This might be an additional consideration in deciding on the appropriate length of the replacement periods for involuntary conversions. Likewise, the additional administrative benefits of conforming the rules may also be taken into account in considering an alternative approach for the personal use situation that would deny like kind nonrecognition treatment in situations where the Section 121 exclusion applies to the

VI. CONCLUSION

The goal of this Article is to analyze and reform the like kind and involuntary conversion rules in light of fundamental tax policies. This Article assumes that the like kind and the involuntary conversion rules are justified by efficiency and perceptual horizontal equity concerns, respectively, and suggests changes to their particular features that are likely to promote these policies as well as administrability. For certain features of the rules, I find that the efficiency and equity underpinnings of the provisions provide limited guidance, and I therefore propose changes aimed at simplifying the administration of the provisions. Overall, the Article's stated assumptions and analysis lead to the following recommended changes:

(i) the use of the like kind standard to determine eligible replacement property under both the like kind and involuntary conversion rules, along with narrowing the like kind standard for real property by employing a categorization approach modeled on the real property classifications used for depreciation purposes,

(ii) the use of an express rollover mechanism under the like kind rule,

(iii) the use of a single, rather than bifurcated, period for replacing assets under the like kind rule, and possibly shortening the replacement period under the involuntary conversion rule,

(iv) the elimination of the requirement under the like kind rule that the relinquished and replacement properties be held either for a business or investment purpose,²⁹⁵ and

(v) either permitting or not permitting the indirect acquisition of replacement property under both the like kind and involuntary conversion rules.

The product of this effort is a simpler, more rational and more unified approach for granting nonrecognition treatment to voluntary and involuntary dispositions of property.

disposition of the relinquished property.

295. As noted earlier, it is worth considering an alternative approach that would eliminate the holding requirement generally, but deny like kind nonrecognition treatment in situations where the Section 121 exclusion applies to the disposition of the relinquished property. *See supra* note 268.