Designing Nonrecognition Rules Under the Internal Revenue Code

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by

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ABSTRACT

Nonrecognition rules are a prominent feature of the income tax laws and are a source of considerable complexity and tax planning. Included among the nonrecognition rules contained in the Internal Revenue Code are provisions applying to like kind exchanges, corporate formations, corporate reorganizations, parent-subsidiary liquidations, and partnership formations and distributions.

The policies that arguably support the nonrecognition rules include the familiar trio of tax policy concerns—efficiency, equity, and tax administration. None of these policies, however, provide a strong basis for most of the nonrecognition rules as currently formulated. The efficiency case generally lacks evidentiary support. The equity case is complicated by the fact that the rules operate in a second-best world where the tax base deviates from economic income. And the tax administration argument for the rules, while plausible in theory, is compromised because nonrecognition frequently occurs where there are no valuation and liquidity concerns as a result of the receipt of publicly traded property or the presence of related cash sales.

This Article generally dispenses with the efficiency and equity bases for the nonrecognition rules because of the aforementioned flaws. As a result, the similar replacement property factor, which is a product of these rationales for nonrecognition and currently is prominent in most nonrecognition provisions, should be generally discarded. This Article proposes a standard for designing nonrecognition rules that generally ignores the similarities or differences in the relinquished and replacement properties, unless the properties are either identical or possess a very high degree of similarity, and instead takes into account the following: presence of difficult-to-value property, presence of illiquid property, use of rules that are narrowly tailored to common transactional forms that are typically selected for significant non-tax reasons, and adherence to certain corporate tax policies. This Article then applies this standard as a basis for suggesting revisions to the current nonrecognition rules. Included among the recommended reforms are (1) eliminating nonrecognition for like kind exchanges; (2) eliminating the control requirement for shareholders to receive nonrecognition upon transfers to corporations, but generally taxing shareholders on the transfer or receipt of publicly traded property; and (3) permitting nonrecognition in corporate reorganizations irrespective of satisfying continuity of interest or continuity of business enterprise requirements, but taxing shareholders on the receipt of publicly traded stock. Overall, the recommended approach and reforms should serve to rationalize and simplify the nonrecognition rules contained in the Internal Revenue Code.

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I. INTRODUCTION

Under the Internal Revenue Code (Code), when a taxpayer sells, exchanges or otherwise disposes of property, the taxpayer realizes gain equal to the excess of (1) the amount of money received plus the fair market value of the property received in the disposition over (2) the taxpayer's adjusted basis in the property disposed of; on a disposition, the taxpayer realizes loss equal to the excess of (1) the taxpayer's adjusted basis in the property disposed of over (2) the amount of money received plus the fair market value of the property received in the disposition.[1] In general, any realized gain or loss has to be recognized,[2] that is, included in income if a gain[3] (absent an applicable exclusion), and potentially deductible if a loss.[4]

If, however, a transaction meets the requirements of a nonrecognition rule, the realized gain or loss in not taken into account for the year in which the disposition occurred but instead is normally deferred through the application of special rules for determining adjusted basis.[5] Included among the nonrecognition rules contained in the Code are provisions applying to like kind exchanges, corporate formations, corporate reorganizations, parent-subsidiary liquidations, and partnership formations and distributions.[6] In some way, most nonrecognition rules require that the property received by the taxpayer in the transaction be somewhat similar to the property relinquished by the taxpayer in the transaction.[7] The rationale for nonrecognition rules has always been somewhat vague, yet these rules are a prominent feature of the income tax laws and are a source of considerable complexity and tax planning.[8]

This Article engages in an evaluation of the nonrecognition rules contained in the Code and, based on this analysis, proposes a standard for designing nonrecognition rules. The policies that arguably support the nonrecognition rules include the familiar trio of tax policy concerns—efficiency, equity, and tax administration.[9] Regarding efficiency, the view is that where a taxpayer exchanges an asset for an asset that

1. I.R.C. § 1001(a)–(b). All section references are to the Internal Revenue Code of 1986, as amended, or to the Treasury regulations thereunder.

2. I.R.C. § 1001(c).

3. I.R.C. § 61(a)(3).

4. I.R.C. § 165(a), (c).

5. *E.g.*, I.R.C. § 1031(a), (d).

6. *See* Part II.

7. *E.g.*, I.R.C. § 1031(a) (requirement that replacement property is like kind); I.R.C. § 1033(a) (requirement that replacement property is similar or related in service or use).

8. *Cf.* Daniel Halperin, Woolworth Lecture, *Saving the Income Tax: An Agenda for Research*, 24 OHIO N.U. L. REV. 493, 498 (1998) (referring to the nonrecognition rules as a "hodge podge [sic] of impossible to reconcile" rules).

9. *See* Part III.A.

is somewhat similar, a taxpayer may be deterred from engaging in the transaction if there was current taxation, given that the exchange may lack significance as far as changing a taxpayer's economic position.[10] The equity basis for nonrecognition is that such a taxpayer may be viewed as being similarly situated to a taxpayer who continues to hold the same property, and because the continued holder would not be taxed currently on any appreciation in the value of the property, then neither should the taxpayer who exchanges the property for similar property.[11] The tax administration policies that arguably support nonrecognition are based on the perceived valuation difficulties and liquidity concerns that occur when taxing a transaction where a taxpayer receives property other than cash.[12]

None of these policies, however, provide a strong basis for most of the nonrecognition rules as currently formulated. The efficiency case generally lacks evidentiary support, given that empirical evidence is lacking, and it is generally difficult to draw well-supported conclusions from general observations.[13] The equity case is complicated by the fact that the rules operate in a second-best world where the tax base deviates from economic income.[14] Horizontal equity comparisons are based on the ability to pay tax, and tax policy analysts usually treat economic income as the best metric to gauge ability to pay. With economic income as the basis for comparisons, horizontal equity provides no support for nonrecognition.[15] And the tax administration argument for the rules, while plausible in theory, is compromised because nonrecognition frequently occurs where there are no valuation and liquidity concerns as a result of the receipt of publicly traded property or the presence of related cash sales.[16]

This Article generally dispenses with the efficiency and equity bases for the nonrecognition rules because of the aforementioned flaws.[17] As a result, the similar replacement property factor, which is a product of these rationales for nonrecognition and currently is prominent in most nonrecognition provisions, should be generally discarded; except in limited cases, there does not appear to be a strong justification for nonrecognition based on the degree of similarity of the property received to that transferred.[18] Instead, this Article mainly focuses on the following as being the appropriate, supportable policies in designing nonrecognition rules: valuation and liquidity difficulties, which can arise in some in-kind exchanges; and minimizing the likelihood that transactions are structured to take advantage of nonrecognition rules.[19] Moreover, because nonrecognition can be inconsistent with certain policies concerning the taxation of corporations and their shareholders, such policies should also be taken into account in formulating nonrecognition provisions.[20]

Thus, this Article proposes a standard for designing nonrecognition rules that generally ignores the similarities or differences in the relinquished and replacement properties, unless the properties are either identical or possess a very high degree of similarity,[21] and instead takes into account the following: presence of difficult-to-value property,[22] presence of illiquid property,[23] use of rules that are narrowly tailored to common transactional forms that are typically selected for significant non-tax reasons,[24] and adherence to certain corporate tax policies.[25] The Article then evaluates the current nonrecognition rules in light of this

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10. *See* Part III.B.2.a.
11. *See* Part III.C.1.
12. *See* Part III.D.1.a., 2.a.
13. *See* Part III.B.2.c., 3.b.
14. *See* Part III.C.2.
15. *See id.*
16. *See* Part III.D.1.b, 2.b.
17. *See* Part III.G.
18. *See* Part IV.A.
19. *See* Part III.G.
20. *See id.*
21. *See* Part IV.A.
22. *See* Part IV.B.
23. *See* Part IV.C.
24. *See* Part IV.D.
25. *See* Part IV.E.

standard and recommends certain reforms, which include: (1) eliminating nonrecognition for like kind exchanges;[26] (2) eliminating the control requirement for shareholders to receive nonrecognition upon transfers to corporations, but generally taxing shareholders on the transfer or receipt of publicly traded stock;[27] and (3) permitting nonrecognition in corporate reorganizations irrespective of satisfying continuity of interest or continuity of business enterprise requirements, but taxing shareholders on the receipt of publicly traded stock.[28] Overall, the recommended approach and reforms should serve to rationalize and simplify the nonrecognition rules contained in the Code.

The Article proceeds as follows. Part II provides an overview of the nonrecognition rules contained in the Code. Part III engages in a critical evaluation of the policies that arguably support nonrecognition. This Part ultimately concludes that although efficiency benefits can be presumed to support nonrecognition in limited cases, the key policies for designing nonrecognition rules should generally be the administrative concerns of valuing property and taxpayer liquidity, minimizing the structuring of transactions to take advantage of nonrecognition, and ensuring that nonrecognition is not inconsistent with certain corporate tax policies. Based on these policies, Part IV develops the aforementioned standard for designing nonrecognition rules. Part V then uses this standard to recommend reforms to certain nonrecognition rules. Part VI concludes the Article.

II. Overview of Nonrecognition Rules

This Part provides a primer on several of the nonrecognition rules contained in the Code: (1) general nonrecognition rules, (2) nonrecognition rules applying to corporation-shareholder transactions, and (3) nonrecognition rules applying to partnership-partner transactions.

A. *General Nonrecognition Rules*

1. *Like Kind Exchanges*

Under section 1031, no gain or loss is recognized if real property[29] held for productive use in a taxpayer's trade or business or investment is exchanged for real property of a like kind that is also held for productive use in the taxpayer's trade or business or investment.[30] Like kind is broadly defined, with almost all real property being treated as like kind.[31] While section 1031 requires an exchange in order to achieve nonrecognition, this is a mere formality as the statute and regulations permit deferred like kind exchanges, which effectively allow taxpayers to sell one real property and use the proceeds to purchase a second real

26. *See* Part V.B.1.

27. *See* Part V.B.2.

28. *See* Part V.B.3.

29. Prior to the Tax Cuts and Jobs Act of 2017, the like kind rule applied to both real and personal property. The 2017 Act removed personal property from the coverage of section 1031. Pub. L. No. 115-97, § 13303, 131 Stat. 2054, 2123 (2017).

30. I.R.C. § 1031(a)(1).

31. Reg. § 1.1031(a)–1(b). For example, under the regulations, city real estate and a ranch or farm are of like kind, as are improved and unimproved real estate. Reg. § 1.1031(a)–1(c). The statute provides an exception by stating that U.S. and foreign realty are not of like kind. I.R.C. § 1031(h). Recently promulgated regulations under section 1031 provide a fairly expansive definition of real property that includes (1) land; (2) improvements to land, which in turn include inherently permanent structures and the structural components of inherently permanent structures; (3) unsevered natural products of land; and (4) water and air space superjacent to land. Reg. § 1.1031(a)–3(a). Under these regulations, real property also includes property that is real property under State or local law. *Id.*

property.[32] If a taxpayer receives money or non-like kind property, commonly referred to as "boot," in a like kind exchange, the taxpayer will recognize realized gain to the extent of boot received.[33]

2. *Involuntary Conversions*

Under section 1033, a taxpayer that experiences an involuntary conversion of property, such as the property's condemnation, destruction, or theft, can elect nonrecognition of gain provided that the taxpayer uses the conversion proceeds to purchase property that is similar or related in service or use generally within the two years after the involuntary conversion.[34] To the extent that the proceeds of the conversion exceed the cost of the similar replacement property, the taxpayer is required to recognize any realized gain.[35] This is functionally similar to the boot rules contained in other nonrecognition rules.[36]

3. *Wash Sales*

Under section 1091, the wash sales rule, a taxpayer is denied a loss deduction on the sale of stock or securities where either 30 days before or after the sale the taxpayer purchases substantially identical stock or securities.[37] To be substantially identical, the stock or securities purchased generally must be in the same company as those sold.[38] While technically a loss deduction rule and not a nonrecognition rule, section 1091 has the same effect as a nonrecognition rule in that the taxpayer cannot take the loss, and, like nonrecognition rules, the provision is accompanied by a special basis rule that preserves the disallowed loss in the new stock or security.[39]

B. *Nonrecognition Rules Applying to Corporation-Shareholder Transactions*

1. *Corporate Formations and Transfers to Controlled Corporation*

Section 351(a) provides a nonrecognition provision that can apply to corporate formations. This section generally provides that no gain or loss is recognized if one or more persons transfer property to a corporation, solely in exchange for stock, and the transferors of property are in control of the corporation immediately after the exchange.[40] Under section 351, a single transferor of property to a corporation can

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32. I.R.C. § 1031(a)(3); Reg. § 1.1031(k)–1; *see* Fred B. Brown, *Proposal to Reform the Like Kind and Involuntary Conversion Rules in Light of Fundamental Tax Policies: A Simpler, More Rational and More Unified Approach*, 67 MO. L. REV. 705, 741 (2002) [hereinafter Brown, *Like Kind*].

33. I.R.C. § 1031(b). As with other nonrecognition rules, a taxpayer in a like kind exchange will receive a special basis in the property received in the exchange that is generally equal to the basis in the property relinquished, plus the gain recognized by the taxpayer on the exchange, and minus the boot received. I.R.C. § 1031(d). This special basis rule applies instead of the cost basis rule that would normally apply, in order to preserve in the replacement property the gain or loss realized on the exchange that went unrecognized. The taxpayer will also generally receive a tacked holding period in the property received in the exchange. I.R.C. § 1223(1).

34. I.R.C. § 1033(a)(2). A purchase of a controlling stock interest in a corporation owning property that is similar or related in service or use would also qualify for elective nonrecognition of gain. *Id.*

35. *Id.*

36. *See supra* note 33 and accompanying text. Pursuant to a special basis rule, any realized gain that is not recognized under section 1033 is preserved in the similar replacement property. I.R.C. § 1033(b).

37. I.R.C. § 1091(a).

38. *See* Rev. Rul. 59–44, 1959–1 C.B. 205.

39. I.R.C. § 1091(d). The taxpayer is also permitted to tack her holding period in the old stock or securities to the holding period in the new stock or securities, another typical feature of nonrecognition rules. I.R.C. § 1223(3).

40. I.R.C. § 351(a). A few types of transactions are excepted from nonrecognition treatment, including transfers to an investment company, as defined in section 351(e)(1) and Reg. § 1.351–1(c). For purposes of section

qualify for nonrecognition treatment, as can two or more persons who each transfer property to the corporation as a part of single exchange. If an exchange otherwise would have qualified under section 351(a) but for the fact that a transferor received money or other property, again referred to as "boot," then any realized gain is recognized by that transferor to the extent of the boot received.[41] If the requirements of section 351 are met, nonrecognition also applies to shareholders' transfers of property to existing corporations.

Under section 1032(a), a corporation recognizes no gain or loss on the receipt of money or other property in exchange for its stock.[42] This rule applies to transfers to a new corporation upon its formation or to transfers to existing corporations.

2. *Acquisitive Corporate Reorganizations*

a. *In General*

The Code provides for nonrecognition treatment for several types of acquisitive reorganizations where two corporations merge or otherwise come together in some fashion. These include an "A" reorganization, which is a merger or consolidation pursuant to a state statute;[43] a "B" reorganization, which is where an acquiring corporation acquires a controlling stock interest in a target corporation solely for voting stock of the acquiring corporation;[44] and a "C" reorganization, which is where an acquiring corporation acquires substantially all of the properties of a target corporation for voting stock of the acquiring corporation (in general) and the target corporation liquidates pursuant to the plan of reorganization.[45]

Besides satisfying the terms of the Code, a qualifying reorganization must also satisfy certain non-statutory requirements. These include the business purpose requirement,[46] the continuity of business enterprise requirement,[47] and the continuity of interest requirement.[48] Under the continuity of business enterprise requirement, the acquiring corporation is required to either continue the target corporation's historic business or use a significant portion of the target's historic business assets in a business.[49] Under the continuity of interest requirement, a sufficient portion of the shareholders' aggregate interest in the

351, section 368(c) defines control as the ownership of at least 80% of the total combined voting power of all classes of stock entitled to vote, and the ownership of at least 80% of the total number of shares of all other classes of stock.

41. I.R.C. § 351(b). A shareholder's basis in stock received in a section 351 exchange is the same as the shareholder's basis in property exchanged for the stock, plus the gain recognized by the shareholder on the exchange, and minus the boot received by the shareholder on the exchange. I.R.C. § 358(a). This special basis rule applies instead of the cost basis rule that would normally apply, in order to preserve in the stock received, the gain or loss realized on the exchange that went unrecognized on the section 351 transaction. Under a special holding period rule, a shareholder in a section 351 transaction would take a tacked holding period in the stock if the property transferred to the corporation is either a capital asset or a section 1231 asset. I.R.C. § 1223(1).

42. I.R.C. § 1032(a). Where property is received by a corporation in a section 351 exchange to the transferor(s), the corporation's basis in the property received is generally the same as the shareholder's basis in the property exchanged for the stock plus any gain recognized by the shareholder on the exchange. I.R.C. § 362(a). A corporation receives a tacked holding period in the property received in a section 351 exchange. I.R.C. § 1223(2).

43. I.R.C. § 368(a)(1)(A).

44. I.R.C. § 368(a)(1)(B).

45. I.R.C. § 368(a)(1)(C). Nonrecognition treatment is also granted to triangular versions of these transactions, where stock of the acquiring corporation's parent corporation is used to acquire the assets or stock of the target corporation. I.R.C. § 368(a)(1)(B)–(C), (a)(2)(D)–(E). Similarly, nonrecognition is permitted where following a qualifying reorganization, the acquiring corporation drops down the acquired assets or stock to a controlled subsidiary. I.R.C. § 368(a)(2)(C); Reg. § 1.368–2(k). *See infra* note 57 for additional types of reorganizations.

46. *See* Reg. § 1.368–1(c).

47. *See* Reg. § 1.368–1(d)(1).

48. *See* Reg. § 1.368–1(e)(1)(i).

49. *See* Reg. § 1.368–1(d)(1).

target corporation must continue in the stock of the acquiring corporation after the reorganization;[50] based on the regulations and case law, the minimum portion appears to be approximately 40%.[51]

b. Consequences to the Parties

The shareholders and security holders of the target corporation generally will not recognize any gain or loss if they exchange stock or securities in the target corporation solely for stock or securities in the acquiring corporation,[52] subject to certain limitations that apply to exchanges involving the receipt of securities.[53] Similar to the rule for section 351 transactions, if an exchange otherwise would have qualified for nonrecognition but for the fact that in addition to stock or securities, a shareholder (or security holder) received boot, then any realized gain is recognized by that shareholder (or security holder) to the extent of boot.[54]

The target corporation in a reorganization will not recognize any gain or loss when it exchanges its property solely for stock or securities of the acquiring corporation.[55] If the target corporation receives boot in addition to stock or securities, then the target corporation still does not recognize gain provided that the boot is distributed to the target's shareholders pursuant to the plan of reorganization.[56] The acquiring corporation in a reorganization will not recognize gain or loss when it transfers its stock in exchange for the assets or stock of the target corporation.[57]

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50. *See* Reg. § 1.368–1(e)(1)(i).

51. *See* Reg. § 1.368–1(e)(2)(v), Exs. 1, 2(ii).

52. I.R.C. § 354(a)(1).

53. I.R.C. § 356(a)(1), (d).

54. I.R.C. § 356(a)(1). Similar to section 351 transactions, the target shareholder's basis in the stock received in a reorganization is the same as the shareholder's basis in stock and securities surrendered, plus the amounts recognized by the shareholder as either gain or dividend on the exchange, and minus the boot received by the shareholder on the exchange. I.R.C. § 358(a). Also similar to the section 351 situation, the target shareholders ordinarily receive a tacked holding period in the stock received in the reorganization. I.R.C. § 1223(1).

55. I.R.C. § 361(a).

56. I.R.C. § 361(b)(1)(A). In general, transfers of boot to creditors in connection with a reorganization are treated as transfers to shareholders for purposes of section 361(b). I.R.C. § 361(b)(3). The target corporation also will not recognize gain or loss when it distributes to its shareholders the stock or securities in the acquiring corporation (along with other consideration) that the target receives in the reorganization. I.R.C. § 361(c).

57. I.R.C. § 1032(a). The acquiring corporation's basis in the target assets or target stock acquired in a reorganization is generally the same basis that the target or the target shareholders had in the transferred property, increased by any gain recognized by the target or the target shareholders, respectively, on the transfer. I.R.C. § 362(b). The acquiring corporation will receive a tacked holding period in the property acquired in the reorganization. I.R.C. § 1223(2).

Besides the acquisitive reorganizations described above, there are several types of other reorganizations that can qualify for nonrecognition treatment. These include acquisitive and divisive "D" reorganizations, "E" reorganizations, "F" reorganizations, and acquisitive and divisive "G" reorganizations. I.R.C. § 368(a)(1)(D)–(G). An acquisitive "D" reorganization is where one corporation (the "transferor corporation") transfers substantially all of its assets to another corporation (the "transferee corporation"); the transferor corporation, one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the transferee corporation immediately after the transfer; and pursuant to the plan of reorganization, the transferor corporation liquidates, distributing stock or securities of the transferee corporation along with any other of its assets. I.R.C. §§ 368(a)(1)(D), 354(b)(1). A divisive "D" reorganization differs from the acquisitive variety in two respects: the transferor corporation transfers only a part of its assets, and the transferor corporation distributes stock or securities of the transferee corporation in a transaction qualifying under section 355, as opposed to liquidating. I.R.C. § 368(a)(1)(D). An "E" reorganization is a recapitalization, which involves situations where investors swap stock or debt in a corporation for stock or debt in the same corporation. I.R.C. § 368(a)(1)(E). Thus, a recapitalization is a remixing of the capital structure of a single corporation. An "F" reorganization is "a mere change in identity, form, or place of incorporation of one corporation, however effected." I.R.C. § 368(a)(1)(F). This is typically the reincorporation of a company in a different state. Finally, a "G" reorganization is the transfer of substantially all or

3. *Corporate Divisions*

a. *In General*

The Code provides for nonrecognition treatment for different types of corporate divisions where the business enterprise of a corporation is divided among separate corporations that are owned by shareholders of the original corporation. There are three types of corporate divisions—spin-offs, split-offs, and split-ups.[58] A spin-off is where one corporation (the "distributing corporation") distributes stock in a controlled corporation to shareholders of the distributing corporation, with the shareholders not surrendering any of their stock in the distributing corporation.[59] A split-off is the same except that the shareholders of the distributing corporation surrender some or all of their stock in the distributing corporation.[60] A split-up is where the stock in two or more controlled corporations is distributed in the complete liquidation of the distributing corporation.[61]

To qualify for nonrecognition treatment, a corporate division needs to satisfy several statutory requirements under section 355 along with non-statutory requirements. These requirements include the active business requirement, under which the distributing corporation and the controlled corporation[62] are each engaged in the active conduct of a trade or business immediately after the distribution, or immediately before the distribution, the distributing corporation's only assets were stock or securities in the controlled corporations, and each controlled corporation is engaged in the active conduct of a trade or business immediately after the distribution.[63] A corporate division must be carried out for one or more corporate business purposes,[64] which is "a real and substantial non Federal tax purpose germane to the business of the distributing corporation, the controlled corporation, or the affiliated group . . . to which the distributing corporation belongs."[65] In addition, a corporate division must not be used principally as a device for distributing the earnings and profits of the distributing corporation, the controlled corporation, or both corporations.[66] A corporate division is also required to meet a continuity of interest requirement, which requires that in the aggregate, the shareholders of the distributing corporation own an amount of stock establishing a continuity of interest in each of the corporations after the division.[67]

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part of the assets of corporation to another corporation in a title 11 bankruptcy case or in a receivership, foreclosure, or similar proceeding in a federal or state court. I.R.C. § 368(a)(1)(G). If substantially all of the assets are transferred, it is an acquisitive "G" reorganization. I.R.C. §§ 368(a)(1)(G), 368(a)(3)(A)–(B), 354(b)(1). If part of the assets is transferred, it is a divisive "G." I.R.C. § 368(a)(1)(G). The tax consequences to the parties to these other types of reorganizations are basically the same as those described above for the parties to the "A," "B," and "C" type reorganizations. These consequences generally include nonrecognition treatment for the shareholders and security holders of the transferor corporation, the transferor corporation, and the transferee corporation.

58. *See* WALTER D. SCHWIDETZKY & FRED B. BROWN, UNDERSTANDING TAXATION OF BUSINESS ENTITIES 559 (2d ed. 2021).

59. *See id.*

60. *See id.* at 560.

61. *See id.*

62. Where the stock of more than one controlled corporation is distributed, each of such controlled corporations must be engaged in the active conduct of a trade or business immediately after the distribution. I.R.C. § 355(b)(1)(A).

63. I.R.C. § 355(b)(1).

64. *See* Reg. § 1.355–2(b)(1).

65. Reg. § 1.355–2(b)(2).

66. I.R.C. § 355(a)(1)(B).

67. *See* Reg. § 1.355–2(c)(1).

b. Consequences to the Parties

In a corporate division qualifying under section 355, shareholders receiving solely stock will not recognize any gain or loss and will not include any amounts in income.[68] Similarly, security holders receiving solely stock or securities in a qualifying corporate division will not recognize any gain, loss or income (subject to certain limitations that apply to exchanges involving the receipt of securities).[69] If a shareholder or securities holder receives boot and the transaction is a split-off or split-up, the shareholder recognizes any realized gain to the extent of the boot received;[70] if the transaction is a spin-off, the boot received is taxed as a dividend to the extent of the earnings and profits of the distributing corporation.[71] In a qualifying corporate division, the distributing corporation generally will not recognize any gain or loss on the distribution of stock or securities in the controlled corporation.[72]

4. Parent-Subsidiary Corporate Liquidations

Under section 332, a parent corporation will recognize no gain or loss when it receives property distributed in the complete liquidation of a subsidiary corporation if the parent owns at least 80% of the vote and value of the subsidiary's stock, and the subsidiary distributes all of its assets within certain time periods.[73] The subsidiary corporation in a section 332 liquidation generally recognizes no gain or loss on distributions to the parent corporation.[74]

C. Nonrecognition Rules Applying to Partnership-Partner Transactions

1. Partner Contributions

Under section 721, generally no gain or loss is recognized to any partner or the partnership on the transfer of property to a partnership in exchange for a partnership interest.[75] A partner's basis in the partnership interest received in a section 721 transaction is generally the same as the partner's basis in the property

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68. I.R.C. § 355(a)(1).

69. I.R.C. §§ 355(a)(1), 356(d)(2)(C).

70. I.R.C. § 356(a)(1).

71. I.R.C. § 356(b). In a qualifying corporate division, a shareholder's aggregate basis in the controlled corporation stock that is received and in the distributing corporation stock that is retained is equal to the shareholder's basis in the stock and securities of the distributing corporation, plus the amounts recognized by the shareholder as either gain or dividend in the transaction, and minus the boot received by the shareholder in the transaction. I.R.C. § 358(a)(1). This aggregate basis is then allocated between the stock of the controlled corporation and the stock of the distributing corporation, based on their relative fair market values. I.R.C. § 358(b)(2); Reg. § 1.358–2(a)(2)(iv).

72. I.R.C. § 355(c)(1)–(2).

73. I.R.C. §§ 332(a)–(b), 1504(a)(2). The parent's basis in the property received in the liquidation is generally the same as the subsidiary's basis in the property. I.R.C. § 334(b). In addition, the parent inherits the earnings and profits of the subsidiary (along with other corporate attributes). I.R.C. § 381(a), (c).

74. I.R.C. § 337(a), (c). These parent-subsidiary nonrecognition rules do not apply to any minority shareholders of the subsidiary corporation. Thus, minority shareholders will recognize gain or loss on the liquidation of the subsidiary. I.R.C. § 331(a). And the subsidiary will recognize gains on liquidating distributions of appreciated property to minority shareholders, although the subsidiary will not recognize losses on distributions of depreciated property to minority shareholders. I.R.C. § 336(a), (d)(3).

75. I.R.C. § 721(a). Excepted from nonrecognition treatment is a transfer to a partnership that would be treated as an investment company (within the meaning of section 351(e); *see supra* note 40), if the partnership were incorporated. I.R.C. § 721(b).

contributed.[76] Similarly, the partnership's basis in the property received is generally the same as the partner's basis in the property.[77]

2. *Partnership Distributions*

Under section 731, a partner generally does not recognize any gain or loss on the receipt of money or property from a partnership in a distribution, either in the liquidating or non-liquidating context.[78] As an exception, in both liquidating and non-liquidating distributions, a partner will recognize gain where the amount of money received exceeds the partner's adjusted basis in the partnership interest.[79] For purposes of this rule, marketable securities are treated as money.[80] Under another exception, in a liquidating distribution where a partner receives no property other than money, inventory, or unrealized receivables, the partner will recognize a loss on the liquidating distribution to the extent that the partner's adjusted basis in the partnership interest exceeds the amount of money and the partnership's adjusted basis in inventory and unrealized receivables.[81] A partnership generally does not recognize any gain or loss on either a liquidating or non-liquidating distribution of property.[82]

III. EVALUATION OF POLICIES UNDERLYING NONRECOGNITION

A. *Overview*

Over the years, various policy rationales have been put forth to justify the nonrecognition rules, which include the familiar trio of tax policy concerns—efficiency,[83] equity,[84] administrability[85]—along with nonrecognition serving as a compromise between accretion and consumption taxes.[86] In addition, certain corporate tax policies have had an influence on these rules.[87]

This Part engages in a critical review of these policy rationales in an effort to identify from a normative perspective the key policies for designing nonrecognition rules. For the efficiency, equity, and administrability rationales, the argument for nonrecognition is explored, which is then followed by a critical evaluation of this argument. This Part also examines the effect of the accretion/consumption tax debate and corporate tax policies on the development of nonrecognition rules.

An important guidepost in evaluating the policy arguments for nonrecognition should be a requirement that policies be supported by sufficient evidence. Ideally, such evidence should consist of empirical findings, but where this is lacking, well-supported conclusions drawn from general observations

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76. I.R.C. § 722. Under the special holding period rule, a partner in a section 721 transaction would take a tacked holding period in the partnership interest if the property contributed to the partnership is either a capital asset or a section 1231 asset. I.R.C. § 1223(1); Reg. § 1.1223–3.

77. I.R.C. § 723. A partnership receives a tacked holding period in the property received in a section 721 transaction. I.R.C. § 1223(2).

78. I.R.C. § 731(a).

79. I.R.C. § 731(a)(1).

80. I.R.C. § 731(c).

81. I.R.C. § 731(a)(2).

82. I.R.C. § 731(b). Under section 751(b) and the regulations thereunder, a partnership is generally required to recognize gain or loss where it transfers unrealized receivables or substantially appreciated inventory items ("section 751 property") in exchange for all or a part of a partner's interest in other partnership property, or where it transfers partnership property other than section 751 property in exchange for all or a part of a partner's interest in section 751 property. I.R.C. § 751(b); Reg. § 1.751–1.

83. *See* Part III.B.

84. *See* Part III.C.

85. *See* Part III.D.

86. *See* Part III.E.1.

87. *See* Part III.E.2.

should be acceptable as a foundation for a particular policy rationale.[88] Hunches or mere speculation should never form the basis for policies that are used to craft tax rules.

For purposes of this Article's evaluation of nonrecognition, it is assumed that the income tax will continue to use a realization system for taxing gains and losses; that is, an accrual or marked-to-market system will not be employed.[89] It is also assumed that, at the very least, cash sales and installment sales for cash will produce recognized gains and losses. The central issue addressed by this Article is whether and the extent to which certain in-kind dispositions of property should receive nonrecognition treatment.

B. Efficiency

1. In General

For tax policy analysts, efficiency analysis can take two forms. First, there is the concern with minimizing the deadweight loss created by the tax system.[90] Deadweight loss results from changes in taxpayer behavior that is caused by taxation, along with the administrative costs involved in complying with and enforcing the tax law.[91] With regard to the former, the tax law should aim to minimize deadweight loss by being neutral in affecting taxpayer behavior.[92] A second concern of efficiency analysis is to correct for market imperfections.[93] This Subpart evaluates nonrecognition under both types of efficiency norms,[94] excluding administrability, which will be addressed in a subsequent Subpart of this Article.[95]

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88. *cf.* Deborah H. Schenk, *An Efficiency Approach to Reforming a Realization-Based Tax*, 57 TAX L. REV. 503, 520 (2004) [Schenk, *Efficiency Approach*] (in applying her methodology to evaluate proposals to expand the tax base by altering the realization rule, stating that the evaluations are incomplete because of the unavailability of necessary empirical evidence, although "[i]n some cases it is relatively easy to determine" the effect of a particular policy instrument).

89. Several articles have proposed and examined schemes for accrual taxation. *See, e.g.*, David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111, 1114–18 (1986) [hereinafter Shakow, *Accrual Taxation*]; Fred B. Brown, "*Complete" Accrual Taxation*, 33 SAN DIEGO L. REV. 1559 (1996) [hereinafter Brown, *Complete Accrual*].

90. *See* Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 TAX L. REV. 1, 4 (1992); David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1650 (1999).

91. *See* Shaviro, *supra* note 90, at 4.

92. *See id*.

93. *See* Charles R. Hulten & Robert A. Klayman, *Investment Incentives in Theory and Practice*, in UNEASY COMPROMISE: PROBLEMS OF A HYBRID INCOME-CONSUMPTION TAX 317, 328–30 (Henry J. Aaron et al. eds., 1988).

94. *Cf.* Weisbach, *supra* note 90, at 1651, 1680 (arguing that line drawing in the tax law should be based on efficiency (minimizing deadweight loss) of competing rules and listing recognition/nonrecognition as an important line in the tax law).

95. Other tax analysts have similarly separated out administrability from other aspects of efficiency. *See* S. REP. NO. 99-313, at 3–8 (1986); Ari Glogower, *Taxing Capital Appreciation*, 70 TAX L. REV. 111, 123 (2016); MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION: PRINCIPLES AND PROBLEMS 25–29 (4th ed. 2001); Shakow, *Accrual Taxation*, *supra* note 89, at 1114–18. This may be appropriate given that administrative costs appear more certain than the costs of tax-induced behavioral changes. *See* Brown, *Like Kind*, *supra* note 32, at 708 n.17.

2. *Neutrality*

a. *Basic Argument for Nonrecognition*

One of the policy rationales often given for nonrecognition is that it promotes neutrality in the disposition of property.[96] This rationale can be found in the legislative history of the versions of the Code's nonrecognition rules that were enacted during the early years of the modern income tax, where the congressional reports accompanying the legislation stated that nonrecognition would permit necessary business readjustments to proceed unimpeded by the current taxation.[97] The basic argument is that without the nonrecognition of realized gain, a taxpayer may be deterred from disposing of property if she would have to pay tax on the gain realized on the transaction.[98] Of course, taxing the gain realized on a transaction may to some extent always impede the occurrence of the transaction; for example, a taxpayer may well refrain from even selling an asset for cash because of reluctance to pay tax on the appreciation in the value of the property since it was acquired. However, the transactions selected by Congress for nonrecognition arguably present special situations where there is a heightened concern that taxing the transaction would only serve to prevent it from happening and thus result only in deadweight loss without any revenue gain. This is because these situations involve exchanges that arguably do not result in a significant change in a taxpayer's economic position, given the degree of similarity in the property relinquished and received.[99]

This efficiency rationale for nonrecognition has apparently led to the similarity requirement that pervades the nonrecognition rules.[100] In some way, most nonrecognition rules require that the property received by the taxpayer in the transaction (the "replacement property") be somewhat similar to the property relinquished by the taxpayer in the transaction (the "relinquished property"). For example, to qualify for nonrecognition under section 351, a shareholder transferring property to a corporation must receive stock in the corporation that provides the shareholder with a controlling interest in the corporation, either alone or as part of the group of shareholders that transferred property to the corporation in the same transaction.[101] Thus, the replacement property is arguably similar to the relinquished property in that it represents a controlling,[102] albeit indirect interest in the property that was transferred to the corporation. Similarly, nonrecognition for a shareholder in an acquisitive corporate reorganization requires that the shareholders of the target corporation, in the aggregate, receive a sufficient stock interest in the acquiring corporation[103] and that the acquiring corporation either continue the business of the target corporation or continue to use a sufficient portion of the business assets of the target corporation.[104] Apparently, these requirements are

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96. *See* Marjorie E. Kornhauser, *Section 1031: We Don't Need Another Hero*, 60 S. CAL. L. REV. 397, 408 (1987) (stating this as a rationale for the like kind rule).

97. *See* H.R. REP. NO. 67-350, at 10 (1921), *reprinted in* 1939–1 C.B. (pt. 2) 168, 175–76; S. REP. NO. 67–275, at 11–12 (1921), *reprinted in* 1939–1 C.B. (pt. 2) 181, 188–89; Brown, *Like Kind, supra* note 32, at 715 n.51; Jerome R. Hellerstein, *Mergers, Taxes, and Realism*, 71 HARV. L. REV. 254, 258–59 (1957); Kornhauser, *supra* note 96, at 402 n.10 (1987); Ajay K. Mehrotra, *The Story of the Corporate Reorganization Provisions: From "Purely Paper" to Corporate Welfare*, *in* BUSINESS TAX STORIES 27, 47–49 (Steven A. Bank & Kirk J. Stark eds., 2005).

98. *See* Hellerstein, *supra* note 97, at 276; Erik M. Jensen, *Uneasy Justification for Special Treatment of Like-Kind Exchanges*, 4 AM. J. TAX POL'Y 193, 213–14 (1985); Kornhauser, *supra* note 96, at 408.

99. *See* Kornhauser, *supra* note 96, at 402 n.10 (quoting a statement in 1923 by Rep. William Green, Acting Chairman of the House Ways and Means Committee, on the intent of the nonrecognition provision in the Revenue Act of 1921, which referred to the prior taxation of exchanges of property for "similar property" as being "injurious to the Treasury and to the transaction of ordinary business").

100. The similarity requirement apparently is also based on the horizontal equity rationale for nonrecognition. *See* Part III.C.1.

101. *See supra* note 40 and accompanying text.

102. It may only be a controlling interest when combined with the interests of the other shareholders that transferred property as a part of the same transaction.

103. *See supra* notes 43–45, 50–51 and accompanying text.

104. *See supra* note 49 and accompanying text.

aimed at ensuring that the nature of the replacement property received by the target shareholders—that being the stock in the acquiring corporation—bears some similarity to the target stock relinquished by these shareholders.[105] A quintessential example of a similar property requirement for achieving nonrecognition is the like kind property requirement under section 1031.[106]

b. More Refined Argument for Nonrecognition

A more refined neutrality argument for nonrecognition has been formulated by Professor Daniel Shaviro, who examined neutrality at two decisional points in time in connection with a taxpayer's holding of an asset.[107] First, there is the point in time when a taxpayer decides to acquire an asset ("Time One").[108] Second, there is the point in time when a taxpayer decides to dispose of an asset ("Time Two").[109] Nonrecognition treatment can reduce deadweight loss at Time Two by removing any disincentive to dispose of an asset that results from taxing the gain realized on the transaction.[110] Whether, and the extent to which, deadweight loss is reduced depends on the tax elasticities of the transactions that are eligible for nonrecognition[111] as well as on the welfare losses associated with any change in taxpayer behavior that results from taxing the transactions.[112]

On the other hand, nonrecognition can also cause additional deadweight loss at Time Two by creating an incentive for taxpayers to structure transactions that qualify for nonrecognition, as opposed to entering into cash sales, for example.[113] In addition, the prospect of nonrecognition at Time Two can create a tax incentive at Time One for investing in assets that can benefit from nonrecognition, as opposed to other

105. Some commentators contend, however, that the continuity of interest requirement is flawed because the economic position of an individual shareholder after an acquisitive reorganization is not directly affected by whether other target shareholders own stock in the acquiring corporation. *See* Stephanie Hoffer & Dale A. Oesterle, *Tax-Free Reorganizations: The Evolution and Revolution of Triangular Reorganizations*, 108 NW. U. L. REV. 1083, 1108–09 (2014). A possible argument in favor of the continuity of interest requirement is that a merger has less significance to the target shareholders if they remain as indirect co-owners of the former assets of the target corporation with substantially the same persons.

106. *See supra* notes 29–31 and accompanying text.

107. Shaviro, *supra* note 90, at 25–26.

108. *Id.* at 25.

109. *Id*.

110. *Id.* at 30–32.

111. *Id.* at 31–32*; cf.* Weisbach, *supra* note 90, at 1661 (if an activity that falls between traditional notions of realization and nonrealization has a high own-elasticity, taxing the activity as a sale will generate a large deadweight loss). It should be noted that Professor O'Reilly has criticized Professor Shaviro's emphasis on elasticity as "likely to prove misleading when applied to realization and recognition." Terrance O'Reilly, *Principles of Efficient Tax Law: Apocrypha*, 27 VA. TAX REV. 583, 592 (2008). According to Professor O'Reilly, while elasticity can be relevant in evaluating the relative efficiency of different tax policies, it has limited relevance in determining whether to impose a tax at all by recognizing gain. *Id.* Professor O'Reilly apparently is contending that Professor Shaviro's use of elasticity to determine deadweight losses is valid only in special cases that do not necessarily exist in the situations analyzed by Professor Shaviro and that this limited scope has not been sufficiently emphasized. *Id.* at 590–93, 616. More generally, Professor Raskolnikov examines the limits of tax law and economics and points out that while these limits constrain the use of economic theory to analyze tax policy, they still permit an economic analysis of incremental changes to the tax system. *See* Alex Raskolnikov, *Accepting the Limits of Tax Law and Economics*, 98 CORNELL L. REV. 523, 589–90 (2013). Even with incremental reforms, however, there are limits on using economic analysis. *See id.* at 583–84 (noting limitations on the marginal efficiency cost of funds approach to analyze incremental changes, such as the need for context-specific empirical estimation and the uncertainty of whether this approach is valid outside of the realm of excise taxes).

112. *See* Shaviro, *supra* note 90, at 31.

113. *See id.* at 36, 45.

assets, thereby increasing deadweight loss at Time One.[114] Finally, providing nonrecognition to certain transactions will inevitably lead to some loss of tax revenue. Assuming that revenue needs are fixed, this revenue loss would need to be made up from some another revenue source, which would produce some deadweight loss.[115] Whether a nonrecognition rule results in an overall reduction of deadweight loss is a function of these competing efficiency costs and benefits.

Based on this framework for analyzing the neutrality case for nonrecognition, Professor Shaviro concludes that it is plausible that a nonrecognition rule could result in net efficiency gains by reducing deadweight loss.[116] However, Professor Shaviro recognizes that the neutrality case for nonrecognition is uncertain because of the lack of needed data on tax elasticities and welfare losses and because of the enormous challenges in obtaining this data.[117]

c. Evaluation of Argument for Nonrecognition

Using Professor Shaviro's framework for analysis, the neutrality case for nonrecognition would depend on whether the Time Two benefits from nonrecognition exceed the resulting Time Two and Time One costs, along with the efficiency costs of raising the revenue lost as a result of permitting nonrecognition. As explained below, there generally appears to be a lack of evidence in support of the neutrality argument for nonrecognition.[118] Except for limited situations, the tradeoff between the Time Two benefits and Time Two and Time One costs seems quite uncertain, and the unknown efficiency costs of replacing the revenue lost due to nonrecognition adds to the uncertainty.[119] Nevertheless, the existence of some Time Two costs resulting from nonrecognition is clear and should factor in the design of any nonrecognition rules.

i. Determining Time Two Benefits

The neutrality case for nonrecognition depends on the presence of sufficient Time Two benefits that outweigh the Time One and Time Two costs of nonrecognition rules. Without sufficient Time Two benefits, the neutrality case for nonrecognition evaporates. Thus, a key question is the extent to which nonrecognition for certain transactions will reduce deadweight losses at Time Two by allowing these transactions to proceed unimpeded by current taxation.

In general, there is currently a lack of evidence to quantify the reduction of deadweight loss at Time Two, either for the nonrecognition rules as currently formulated or reformulated versions of these rules. First, as mentioned above, there is simply a dearth of empirical evidence on the tax elasticities and welfare losses, which is necessary to demonstrate an empirical case for Time Two benefits resulting from nonrecognition.[120] The extent to which an exchange of a particular property for another particular property

114. *See id.* at 25–28; *cf.* Jensen, *supra* note 98, at 214 (stating that the like kind exchange rule does not promote economic efficiency because it encourages overinvestment in the property that is suitable for like kind exchanges).

115. *See* Shaviro, *supra* note 90, at 24, 32.

116. *See id.* at 6, 45, 66.

117. *See id.* at 6, 25, 32, 66.

118. In addition, there is also the concern that this efficiency argument for nonrecognition may be based on economic theories that only apply in limited situations. *See supra* note 111.

119. In a previous article, I assumed the correctness of this efficiency argument for purposes of recommending reforms to the like kind rule. *See* Brown, *Like Kind*, *supra* note 32, at 722. In this Article, I no longer engage in this assumption.

120. *See supra* note 117 and accompanying text; *cf.* Herwig J. Schlunk, *Rationalizing the Taxation of Reorganizations and Other Corporate Acquisitions*, 27 VA. TAX REV. 23, 35 (2007) (stating that "woefully lacking in empirical support" is the proposition "that the corporate reorganization provisions encourage economically efficient transactions that otherwise would not occur").

is tax elastic is simply not known given the available evidence.[121] This is further compounded by the lack of needed data to determine the welfare losses associated with any behavioral changes that would occur if certain property exchanges were subject to tax.[122]

Nevertheless, empirical evidence, which would be ideal if available, is not the only basis for determining tax policy. Specifically, in the case of efficiency analysis, where tax policy analysts face daunting empirical challenges, yet decisions need to be made, well-supported conclusions drawn from general observations should be acceptable as a foundation for a particular policy rationale.[123] For the most part, however, this too is lacking for the neutrality case for nonrecognition rules. It is plausible that exchanges of property for nearly identical property may be severely deterred if gain must be recognized, because of a relative lack of significance in the exchange. But there seems to be little basis that this would hold true if the replacement property varies to a significant degree from the relinquished property. Yet the current nonrecognition rules allow for nonrecognition for exchanges of property for replacement property that can be materially different than the relinquished property.

For example, the like kind exchange provision permits nonrecognition for almost any exchange of real property for real property, no matter how different.[124] Similarly, section 351 provides shareholders with nonrecognition upon transfers to corporations even where they may materially alter their economic position with respect to the transferred property. An example is where each of several shareholders transfers a particular asset to a newly formed corporation as part of a single transaction, in exchange for a portion of the corporation's stock. Each shareholder goes from holding a direct interest in a particular asset to holding an indirect interest (via the stock received) in a collection of assets, only one of which is the asset transferred by the shareholder. The same occurs with transfers to partnerships, where two or more partners each transfer property to a partnership and receive nonrecognition under section 721.[125] Nonrecognition for acquisitive

121. *See* Shaviro, *supra* note 90, at 31–32 (stating that the number of transactions that taxpayers change because of the realization rules is difficult to measure, and that "the 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"); *cf.* Schenk, *Efficiency Approach*, *supra* note 88, at 507 n.15 (in evaluating whether and how to constrict the realization rule to increase the tax burden on capital, stating the extreme difficulty in anticipating and measuring changes in taxpayer behavior).

122. *See* Shaviro, *supra* note 90, at 31 (stating that the average welfare loss per change of transaction because of the realization rules is essentially impossible to measure).

123. *Cf. id.* at 32 (stating that some general observations can be made by tax elasticity); Schenk, *Efficiency Approach*, *supra* note 88, at 507 (stating that in some cases it is relatively easy to speculate how easy it will be to avoid rules that increase the tax burden on capital).

124. *See supra* note 31 and accompanying text; Brown, *Like Kind*, *supra* note 32, at 735; Kornhauser, *supra* note 96, at 410. In this regard, the changes made to the like kind exchange provision in the Tax Cuts and Jobs Act of 2017 were somewhat ironic. The 2017 legislation eliminated personal property from the coverage of the provision (Pub. L. No. 115-97, § 13303, 131 Stat. 2054, 2123 (2017)), and the like kind rules for personal property had required that the relinquished and replacement properties have a fairly high degree of similarity. Reg. § 1.1031(a)–2; *see* Brown, *Like Kind*, *supra* note 32, at 729–30 (discussing these rules). Consequently, while there was no evidence that allowing nonrecognition for like kind personal property exchanges produced significant Time Two benefits, it would seem more plausible that such exchanges produced these benefits as compared to like kind exchanges of real property. Congress's stated reason for removing personal property from the coverage of section 1031 is the increased and expanded expensing for tangible personal property under the 2017 tax act. H.R. REP. NO. 115-409, at 255 (2017). Apparently, Congress felt that nonrecognition for personal property is not necessary given the expanded expensing for most types of personal property. *See* Cody Wilson, *Taxing Trades: Proposals to Keep Moneyball Out of Tax Law*, 72 SMU L. REV. 953, 969 (2019).

125. Professor Shaviro recognizes the nontax significance that occurs when a partner transfers property to a partnership but offers another rationale for not taxing the partner on this change: the tax could be easily avoidable by having the partner lease the property to the partnership; a lease is likely feasible because the parties have indicated that they are willing to enter into an ongoing contractual relationship given their willingness to form a partnership. *See* Shaviro, *supra* note 90, at 49–50. Professor Shaviro's observation about the willingness of the parties to enter into a lease as a substitute for contributing the property to the partnership is certainly plausible, but there may be significant

reorganizations follows a similar pattern: shareholders of the target corporation can receive nonrecognition on the exchange of stock in the target corporation for stock in the acquiring corporation, even though such shareholders go from holding an indirect interest in the assets of the target corporation to holding an indirect interest in the assets of acquiring corporation, which now include, among its assets, the former assets of the target corporation.[126] There is simply no evidence as to the extent to which nonrecognition for transactions of these types results in a reduction of deadweight loss at Time Two.[127]

Indeed, the degree of non-tax significance in some of the transactions qualifying for current nonrecognition treatment is arguably no less than in some sales of property for cash. While in both theory and practice, cash dispositions generally need to be taxed in an income tax system, nonrecognition could be provided where the proceeds of a cash disposition are rolled over into another investment. This occurs under section 1045 where a taxpayer sells qualified small business stock[128] and reinvests the proceeds in other qualified business stock within 60 days of the sale; if the taxpayer elects, gain is not recognized on the sale.[129] Under a neutrality rationale for nonrecognition that focuses on the degree of non-tax significance, consistency suggests that nonrecognition should also be permitted for sales and related reinvestments that have a degree of non-tax significance that is similar to the non-tax significance of certain corporate formations, acquisitive corporate reorganizations, and the like. Yet doing so could result in

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economic differences between these two arrangements that render the leasing alternative unsuitable for both the partner holding the property and the other partners.

126. *See* AM. L. INST., FEDERAL INCOME TAX PROJECT, SUBCHAPTER C 157 (1982) [hereinafter ALI Project] (concluding that the avoiding-tax-on paper-gains reason for nonrecognition treatment for acquisitive corporate reorganizations "fails to support the reorganization provisions in their full scope. From the beginning, reorganization has been defined to include mergers and other acquisitions that clearly involve a very substantial change in investment"); Shaviro, *supra* note 90, at 56 (stating that many commentators have noted that the acquisitive reorganization provisions do not always fit the no significant change rationale); Hellerstein, *supra* note 97, at 261, 266–70 (suggesting that many exchanges receiving nonrecognition treatment under the corporate reorganization provisions are merely changes in form "only as judged by highly artificial standards," and that judged by business standards "involve substantial changes of economic position"; stating that a certain merger that qualifies as a corporate reorganization is a change in form and not substance "borders on fantasy"); Calvin H. Johnson, *Taxing the Publicly Traded Stock in a Corporate Acquisition*, 124 TAX NOTES 1363, 1365–66 (Sept. 28, 2009) [hereinafter Johnson, *Publicly Traded Stock*] (pointing out that a transaction qualifies as a reorganization "even when a whale swallows a minnow and the minnow shareholders end up with very different interests from what they previously held"; pointing out that a shareholder that receives publicly traded stock in an acquisitive corporate reorganization continues her interest "only in the most esoteric sense"); Mehrotra, *supra* note 97, at 67 (referring to the skepticism expressed by some legislators that the broadened corporate reorganization rule enacted in 1921 was consistent with the policy of not taxing transactions that amounted to a continued a shareholders' interests); *cf.* Bernard Wolfman, *"Continuity of Interest" and the American Law Institute Study*, 57 TAXES 840, 841–42 (1979) (suggesting that the continuity of interest doctrine that applies to corporate reorganizations has little substance). By its very nature, acquisitive corporate reorganizations cannot be "pure" change in form transactions because they involve two corporations and the resulting product is quite different than what the target shareholders held prior to the transaction. It should be noted that some commentators have made an "all or nothing" argument for nonrecognition for acquisitive reorganizations, contending that as long as some assets of acquiring corporation after transaction had belonged to target then the target shareholders should receive complete (or partial, if there is boot) nonrecognition treatment, as opposed to complete recognition treatment. *See* Steven A. Bank, *Mergers, Taxes, and Historical Realism*, 75 TUL. L. REV. 1, 75 (2000); Shaviro, *supra* note 90, at 56.

127. While this is true, it should be noted that the case for nonrecognition treatment for transactions with some significance is stronger with the fair market value basis rule under section 1014 for transfers upon death, as compared to without this rule. With section 1014, taxpayers are less likely to engage in taxable transfers in order to benefit eventually from the typical step up in basis at death, and consequently, transactions with some significance may be deterred by the prospect of current taxation. *Cf.* Shaviro, *supra* note 90, at 45–46 (stating that the case against the broad definition of like kind for real property would be even stronger if not for section 1014).

128. I.R.C. § 1202.

129. I.R.C. § 1045

nonrecognition for a large portion of cash dispositions[130] and increase the need to raise tax revenue from other sources. Increasing the number of opportunities for nonrecognition provisions would also add to Time One costs of nonrecognition. Thus, nonrecognition apparently cannot be permitted for all transactions with seemingly similar tax elasticities. The fact that nonrecognition can be provided to only some of the transactions with similar non-tax significance suggests that it is difficult to apply the neutrality rationale in a principled manner, unless this rationale is limited to transactions that clearly lack non-tax significance based on the close similarities of the properties exchanged.

Of course, in theory it may be possible to reform the nonrecognition rules so that nonrecognition is more likely to produce greater Time Two benefits, but again evidence on the extent of these benefits is lacking. While there are a few types of exchanges that appear so insignificant that large Time Two benefits from nonrecognition may be presumed—for example, the reincorporation of a corporation in a different state, or the transfer of assets from a parent corporation to its wholly owned subsidiary corporation—for most transactions, quantifying such benefits for purposes of a comparison with efficiency costs seems quite uncertain.[131] And limiting nonrecognition to the few types of exchanges that appear to have large Time Two benefits would deny nonrecognition for other types of exchanges, which may warrant nonrecognition for other policy reasons.

ii. Determining Time Two Costs

As mentioned previously, nonrecognition can also cause deadweight loss at Time Two by creating an incentive for taxpayers to structure transactions in a way to qualify for nonrecognition.[132] For example, taxpayers disposing of real property will frequently structure the transactions as like kind exchanges, by using commercial facilitators to engineer three-party transactions that ultimately result in the exchange of the relinquished realty for like kind real property. Indeed, an entire industry has developed that provides section 1031 exchange services.[133] While anecdotal, the evidence suggests that taxpayers are structuring what otherwise would be cash sales of real property as qualifying three-party like kind exchanges to take advantage of the nonrecognition treatment afforded by section 1031.[134]

More generally, there is strong support for the notion that taxpayers will structure their affairs to take advantage of tax rules to the extent that the tax savings reaped by doing so exceed the costs involved, administrative and otherwise.[135] As tax policy analysts have pointed out, it is important to try to gauge the

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130. *Cf.* Schlunk, *supra* note 120, at 45 (viewing section 1045's nonrecognition treatment as based on the underlying theory of not wanting to tax "paper profits" that could vanish if the subsequent investment performs poorly; concluding that this theory would apply to any cash sale of an asset followed by a reinvestment in another asset).

131. *Cf.* Schenk, *Efficiency Approach*, *supra* note 88, at 518 (concluding that there are too many unknowns to make an exact calculation of the benefits and costs of any realization-broadening proposal, but that some possibilities can be eliminated where inefficiency will surely result).

132. *See supra* note 113 and accompanying text; Shaviro, supra note 90, at 36 (stating that nonrecognition rules that defer gain "appear more likely to increase the number of tax-minded transactions, since they create opportunities that taxpayers may seek to exploit"); *cf.* Schenk, *Efficiency Approach*, *supra* note 88, at 516 (pointing out the resulting deadweight loss when taxpayers switch to transactions that are not taxed).

133. *See* Allison Bethell, *The 6 Best 1031 Exchange Companies of 2021*, BALANCE, https://www.thebalance.com/best-1031-exchange-companies-5077551 (updated May 2, 2021) (reviewing companies providing like kind exchange services).

134. *See* Shaviro, *supra* note 90, at 45 (stating that anecdotal evidence tends to confirm that like kind exchanges involving real property frequently are substitutes for taxable sales); Kornhauser, *supra* note 96, at 411 (stating that section creates its own inefficiencies by locking capital into like kind property); Calvin H. Johnson, *Impose Capital Gains Tax on Like-Kind Exchanges*, 121 TAX NOTES 475, 477 (Oct. 27, 2008) [hereinafter Johnson, *Like Kind Exchanges*] (stating that it can be expected that if section were repealed, like-kind exchanges would be replaced by cash sales).

135. An example of this are corporate tax shelters. *See* STEPHEN SCHWARZ & DANIEL J. LATHROPE, FUNDAMENTALS OF CORPORATE TAXATION 619–20 (10th ed. 2019).

response of taxpayers to proposed changes in the tax law, in order to determine whether these changes produce overall gains in efficiency.[136] In this regard, Professor Deborah Schenk has examined actual and proposed changes to expand the tax base by increasing the number of realization events.[137] Professor Schenk analyzed the efficiency consequences of these changes by trying to ascertain the change in the elasticity of income that results from the change under consideration.[138] According to Professor Schenk, incremental changes that decreased the elasticity of taxable income would be desirable.[139] Where taxpayers find it difficult to avoid the particular rule increasing realization events, this will decrease the elasticity of income.[140] Conversely, a rule increasing realization that is easy to avoid would have little or no change on the elasticity of income.[141] To determine how easy or hard it is for taxpayers to avoid the proposed rule that increases the number of realization events, it must be determined if the remaining opportunities for avoiding realization are adequate substitutes for the transaction subject to taxation under the proposed rule[142] and how easy it is for taxpayers to move to such substitutes.[143] The latter inquiry would involve an examination of tax rule restrictions, the direct costs of substitutions, and, apparently most importantly, the presence of frictions—restraints that are external to the tax system.[144]

A similar approach can be applied to nonrecognition rules to try to determine the extent to which these rules will produce Time Two costs. As opposed to expanding the tax base by adding to the situations where realization occurs, nonrecognition rules contract the tax base (to the extent there are gains from such transactions covered by these rules). Nevertheless, Professor Schenk's methodology[145] for ascertaining the efficiency consequences of rules is helpful because it can be used to gauge the taxpayer's responses to rules—in the case of nonrecognition, the extent that they will attempt to have the rule apply to transactions with realized gains (as opposed to avoid the rule, in the case of measures that add to realization events).

In this regard, the first question should be whether a transaction satisfying a nonrecognition rule can serve as an adequate substitute for a transaction generating recognized gain, which is typically a sale for cash or an installment obligation. Taking a like kind exchange as an example, the question would be whether an exchange of real property for other real property is an adequate substitute for a sale of the real property for cash or an installment obligation. This would depend on what the seller intended to do with the proceeds of the sale. Obviously, if the seller's intent were to consume the proceeds, then a like kind exchange for real property would not be an adequate substitute for sale of real property for cash or an installment obligation. If, however, the intent were to reinvest the proceeds, then the question becomes whether an investment in replacement real property that qualifies the transaction for nonrecognition under

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136. *See* Schenk, *Efficiency Approach*, *supra* note 88, at 503–04.

137. *Id*.

138. *Id*. at 504.

139. *Id*. at 505. It should be noted that Professor O'Reilly argues that Professor Schenk's application of economic theory on the elasticity of taxable income is out of context. *See* O'Reilly, *supra* note 111, at 604. More specifically, Professor O'Reilly contends that the work on the compensated elasticity of taxable income by Joel Slemrod and Wojciech Kopczuk, which Professor Schenk draws on, provides that a tax policy is more economically desirable the more it reduces the elasticity of taxable income, "assuming that the income tax rate is set, and the policy is optimally implemented." *Id*. at 602. According to Professor O'Reilly, because Slemrod and Kopczuk's views on the benefits of decreasing the elasticity of taxable income is based on these assumptions, their work "does not justify the use of the elasticity of taxable income to evaluate whether a potential expansion of the income tax base is economically desirable." *Id.* at 602–03.

140. *See* Schenk, *Efficiency Approach*, *supra* note 88, at 505.

141. *See id*. at 506.

142. *See id*. at 507.

143. *See id*. at 508.

144. *See id*. Even if a proposed rule decreases the elasticity of income, it may not necessarily be efficient. Whether the proposed rule is efficient would depend on whether the benefits of decreasing the elasticity of income exceed the costs associated with the proposed rule. *See id*. at 506. These costs include taxpayer compliance costs, government administrative costs, taxpayer avoidance costs, and the deadweight losses that occur when taxpayers change their behavior to avoid the proposed rule. *See id*. at 514–16.

145. *See supra* notes 139–144 and accompanying text.

section 1031 is an adequate substitute for the investment contemplated by the seller. This should depend in part on the breadth of the property that qualifies for nonrecognition under section 1031. Although like kind property is limited to real property, because almost all real property is considered like kind,[146] qualifying replacement property under section 1031 may well serve as an adequate substitute in many situations.

The next question would be whether the taxpayer would be able to move to adequate substitutes. As mentioned above, this would involve an examination of tax-rule restrictions, the direct costs of substitutions, and the presence of frictions. Again using the like kind provision as an example, through the use of commercial facilitators, it is relatively easy to satisfy the requirements under section 1031 where the replacement property qualifies as like kind, and the direct costs of complying with section 1031—the legal and commercial facilitator expenses—are relatively insignificant. And assuming that the taxpayer is willing to invest the proceeds of the property disposition in real property generally, frictions (i.e., non-tax restraints) would typically not be present. Thus, it appears that the like kind provision does produce significant Time Two costs by incentivizing taxpayers to structure transactions to qualify under the provision.[147]

As with the Time Two benefits stemming from nonrecognition rules, actually quantifying any Time Two costs is fraught with great difficulty given the lack of data on tax elasticities and welfare losses. Nevertheless, it seems that nonrecognition rules do generate such costs. And if it is determined that a nonrecognition rule should exist, efforts should be made to minimize the resulting Time Two costs. In this regard, the above analysis suggests that rules with liberal requirements that permit nonrecognition for broad categories of transactions, both in terms of the types of eligible replacement property and form of transactions, such as the like kind provision, generate significant Time Two costs by affording taxpayers with ample opportunities for structuring transactions that qualify for nonrecognition yet can be adequate substitutes for cash sales.[148] Conversely, narrower nonrecognition rules should produce lower Time Two costs by reducing the extent to which a nonrecognition transaction can serve as an adequate substitute for a transaction generating recognized gain and by reducing a taxpayer's ability to move to adequate substitutes.[149] Moreover, to the extent that there are likely significant non-tax reasons for selecting a transactional form that benefits from nonrecognition, the concern that a transaction is chosen for tax reasons is lessened. For example, several taxpayers who each transfer operating assets to a newly formed corporation in exchange for stock therein would presumably do this for business reasons, as opposed to taking advantage of nonrecognition treatment under section 351. Significant non-tax reasons for choosing a transactional form also serve as frictions that further limit a taxpayer's ability to select a nonrecognition transaction as a substitute for a recognition transaction.[150] These should be important considerations in designing any nonrecognition rules.

iii. Determining Time One Costs

As mentioned above, the prospect of nonrecognition can create a tax incentive at Time One for investing in assets that can benefit from nonrecognition, as opposed to other assets, thereby increasing deadweight loss at Time One.[151] Of course, the prospect of nonrecognition is not the only cause for the tax incentive to invest in certain assets over other assets. Another, more important cause is the realization rule, which lowers

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146. *See supra* note 31 (stating that the regulations under section 1031 provide that city real estate and a ranch or farm are of like kind, as are improved and unimproved real estate).

147. *See supra* note 113 and accompanying text.

148. *Cf.* Weisbach, *supra* note 90, at 1661 (stating that an activity that is a close substitute for selling should generally be taxed as a sale in order to lower deadweight losses).

149. As an example of this approach, in 1923 Congress removed financial assets, such as stocks and bonds, from the coverage of the like kind rule because taxpayers were using exchange departments established by brokers to exchange appreciated securities for other securities and avoid taxable gain; however, taxpayers were selling the depreciated securities for cash to recognize losses. Johnson, *Like-Kind Exchanges*, *supra* note 134, at 478.

150. *Cf.* Schenk, *Efficiency Approach*, *supra* note 88, at 511 (discussing how policymakers can take advantage of frictions, such as firms' desire to keep earnings high, in designing reforms to the realization rule).

151. *See supra* note 114 and accompanying text.

effective tax rates, and thereby probably encourages taxpayers to investment in growth assets, whose income can be deferred under the realization rule, versus yield assets, whose income is taxed currently. While tax policy analysts generally acknowledge the Time One costs of the realization rule—i.e., the overinvestment in growth assets[152]—the incremental Time One costs of nonrecognition rules are less clear. Nevertheless, because nonrecognition and the resulting additional deferral can lower effective tax rates beyond those under the realization rule alone, and lower effective tax rates for assets should cause additional investment in these assets, there appears to be a strong case that the nonrecognition rules do result in some Time One costs, by adding to those caused by the realization rule.

To the extent that nonrecognition is available for certain assets that benefit from the realization rule but not for other assets that also benefit from the realization rule, Time One costs would also be produced. For example, the like kind exchange provision may provide a tax incentive for investing in real property rather than in personal property, because nonrecognition is available under the provision for the former but not the latter. If the nonrecognition rules for corporate reorganizations were revised so that the receipt of publicly traded stock no longer qualified for nonrecognition at the shareholder level, this potentially could create Time One costs by incentivizing investments in privately held stock over publicly traded stock.[153]

As with the Time Two benefits and costs resulting from nonrecognition, the magnitude of the Time One costs is just as uncertain given the lack of information on tax elasticities and welfare losses. Thus, while it can be presumed that nonrecognition will carry with it some Time One costs, it seems nearly impossible to quantify these with any degree of precision for purposes of comparing the efficiency costs to the efficiency benefits of nonrecognition. Nevertheless, as with Time Two costs, if nonrecognition rules do exist, efforts should be made to minimize the resulting Time Two One costs. In this regard, it would seem that as with the prescription for minimizing Time Two costs, narrower nonrecognition rules should produce lower Time One costs by limiting the types of property that can benefit from nonrecognition treatment, especially if there are frictions that limit the use of these rules.

iv. Efficiency Costs of Raising Revenue Lost Due Nonrecognition

A final factor in evaluating the neutrality costs and benefits of nonrecognition are the deadweight losses associated with raising the revenue that is lost as a result of permitting nonrecognition for certain transactions. Even if nonrecognition treatment is limited to relatively tax elastic transactions, some dispositions would still likely have occurred if gain were recognized, and consequently some tax revenue would be forgone with a nonrecognition rule.[154] A fortiori, the revenue losses should be larger with nonrecognition rules that are broader or more widely available. With fixed revenue needs, the revenue surrendered by affording nonrecognition will need to be recouped, and, assuming that this is done via taxes, deadweight losses will be generated.[155] Consequently, even if the Time Two benefits stemming from nonrecognition exceed the Time Two and Time One costs, permitting nonrecognition could cause net efficiency costs when the deadweight losses of raising the lost revenue are taken into account. Determining the efficiency costs of raising the revenue lost due to nonrecognition suffers from the same empirical challenges in measuring other efficiency costs and benefits. Moreover, evaluating these additional deadweight losses is complicated by the fact there may be several alternative ways of generating the needed revenue.[156]

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152. *See* Brown, *Complete Accrual*, *supra* note 89, at 1571–72.

153. *See infra* notes 336–340 and accompanying text.

154. This assumes that the macroeconomic effects of nonrecognition do not produce tax revenue gains that offset these tax revenue losses.

155. *Cf.* Johnson, *Publicly Traded Stock*, *supra* note 126, at 1366 (stating that the tax revenue forgone by not taxing shareholders' receipt of publicly traded stock in acquisitive reorganizations must be collected from "some inferior source").

156. *See* Weisbach, *supra* note 90, at 1665 (noting that the problem with applying economic models to line drawing is that revising the law will change tax revenues, and the offsetting changes to keep revenues constant and their effects on deadweight losses are not known).

3. *Correcting for Market Imperfections*

a. *Argument for Nonrecognition*

Another policy rationale often given for nonrecognition is that it promotes economic growth. The argument is that nonrecognition treatment provides a tax subsidy for financial activities, such as mergers and other forms of acquisitive transactions, corporate formations, and certain property exchanges, which thereby stimulates economic activity.[157] The legislative history to the early versions of the Code's nonrecognition rules mentioned this as a reason for enacting the rules.[158] Indeed, stimulating commercial activity may have been the primary policy underlying the early versions of the corporate reorganizations provisions in the 1920s and 1930s.[159] Similarly, some commentators tout the promotion of economic growth as a justification for the corporate reorganizations rules.[160]

In terms of efficiency, the argument is that by promoting economic growth, nonrecognition corrects for market imperfections, such as inadequate economic growth, underemployment of resources, and externalities, which interfere with the perfect operation of the market.[161] Tax rules that are designed to overcome market imperfections are referred to as Pigovian taxes.[162]

b. *Evaluation of Argument for Nonrecognition*

The case for using nonrecognition rules as Pigovian taxes to address market imperfections suffers from two flaws. First, there is no evidence to suggest that the nonrecognition rules address identified market imperfections.[163] While Congress's desire to stimulate the economy was a cause for the first iterations of the nonrecognition rules, there was no empirical evidence indicating the presence of market imperfections, such as inadequate economic growth or underemployment of resources. In this regard, the legislative history to the enactment of the reorganization provisions indicates that Congress assumed that these rules promoted

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157. *See* Bank, *supra* note 126, at 28 n.160 (referring to this explanation for the corporate reorganization provisions and citing to legal scholarship supporting this); Hellerstein, *supra* note 97, at 276 (mentioning, but not endorsing, that a major policy argument for nonrecognition for corporate reorganizations is that "tax-free mergers are essential to the healthy expansion of our economy"); Kornhauser, *supra* note 96, at 400 (stating that one of Congress's reasons for the like kind rule was to promote economic growth).

158. *See* Kornhauser, *supra* note 96, at 433–41; Mehrotra, *supra* note 97, at 78–86.

159. *See* Kornhauser, *supra* note 96, at 433–41; Mehrotra, *supra* note 97, at 78–86.

160. See Note, *Reorganization Policies and Provisions: A Need for Clarification and Change*, 14 STAN. L. REV. 848, 853 (1962) (referring to commentators that stress the benefits to industrial and economic growth that result from corporate reorganizations).

161. *Cf.* Hulten & Klayman, *supra* note 93, at 328–30 (discussing in general taxes that are designed to correct for market imperfections).

162. *See* Weisbach, *supra* note 90, at 1654; *cf.* Victor Fleischer, *Curb Your Enthusiasm for Pigovian Taxes*, 68 VAND. L REV. 1673, 1687 (2015) (tax expenditures can be referred to as Pigovian subsidies because they are often used to accomplish social policy goals; referring to a definition of tax expenditures that includes the deferral of tax liability).

163. *See* Bank, *supra* note 126, at 29 (stating that even if mergers and acquisitions may be economically beneficial, "economists contend that the reorganization provision is not necessary to encourage such activity"); Milton Sandberg, *The Income Tax Subsidy to "Reorganizations,"* 38 COLUM. L REV. 98, 98, 101–02 (1938) (stating that there is no satisfactory explanation why the corporate reorganization provisions were enacted; questioning why the corporate reorganization provisions encourage some transactions but not others). Similarly, as a few tax scholars have stated, there is no evidence that the realization rule was intended to address any market inefficiency or that the rule actually addresses any market inefficiency. *See* HENRY J. AARON & HARVEY GALPER, ASSESSING TAX REFORM 56–57 (1985); Brown, *Complete Accrual*, *supra* note 89, at 1572–73; Deborah H. Schenk, *A Positive Account of the Realization Rule*, 57 TAX L. REV. 355, 389 n.156 (2004) [hereinafter Schenk, *Positive Account*].

efficient transactions and provided businesses with flexibility; in the debates on these rules, Congress did not directly study or discuss the intuition that efficiency would be advanced.[164]

A second problem with the case for using the nonrecognition rules to correct market imperfections is common to designing all Pigovian taxes: the vast amount of information about the economy that is necessary to design such taxes.[165] Even if market imperfections were present, there is simply no empirical data that supports the use of nonrecognition as a means to address the factors that prevent the markets from functioning perfectly.[166] With regard to the nonrecognition rules for mergers and other acquisitive corporate reorganizations, the data suggests that merger activity results in little public benefit and that the effects of merger activity may actually be harmful by reducing the number of healthy competitors in a given market.[167] Thus, providing a tax incentive for corporate mergers and acquisitions via nonrecognition rules may actually worsen market imperfections rather than correct them. Furthermore, in a comprehensive analysis of the empirical data bearing on the efficiency consequences of the reorganizations provisions, Professor Brauner concluded that efficiency does not justify these provisions because the rules aim to encourage reorganizations that use stock consideration rather than cash consideration, and there is no indication that stock transactions are superior from a wealth-creating, socially desirable perspective; in fact, stock transactions may be inferior from this perspective.[168] Professor Brauner also states that there is no indication that the reorganization provisions correct any potential market failures and that sometimes the provisions may exacerbate market inefficiencies.[169] More generally, Professor Brauner questions the ability to correctly design tax rules to promote the desirable features of corporate mergers and acquisitions, given the variety and constant evolution of these transactions,[170] and concludes that even if M&A transactions are value creating and socially beneficial, the available data does not permit the determination of the situations

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164. *See* Yariv Brauner, *A Good Habit, or Just an Old One? Preferential Tax Treatment for Reorganizations*, 2004 BYU L. REV. 1, 17.

165. *See* Brown, *Like Kind*, *supra* note 32, at 708 n.17 (mentioning the apparently strong practical case against using Pigovian taxes); Fleischer, *supra* note 162, at 1710 (stating that "[t]he academic enthusiasm for Pigovian taxes outpaces the ability of our political institutions to design and implement taxes"; although carbon production and similar activities are good candidates for Pigovian taxes, "we should not substitute glib back-of the-envelope policy design for the rigorous work our complex problems demand"); *cf.* Hulten & Klayman, *supra* note 93, at 318 (stating that it would be virtually impossible to obtain the information about the economy and social values to design optimal tax rates on capital income).

166. *See* Schlunk, *supra* note 120, at 35 (2007) (stating that "woefully lacking in empirical support" is the proposition "that the corporate reorganization provisions encourage economically efficient transactions that otherwise would not occur").

167. *See* Ulysses S. Crockett, Jr., *Federal Taxation of Corporate Unifications: A Review of Legislative Policy*, 15 DUQ. L. REV. 1, 26–29 (1976); *see also* Hellerstein, *supra* note 97, at 279–80 (discussing the potential negative effects of encouraging mergers by increasing the concentration of industry, developing oligarchy in industry, and eliminating small businesses what are fundamental to economic health).

168. *See* Brauner, *supra* note 164, at 18, 25–27, 45–47 (also stating that M&A transactions that are motivated by managers' interests are likely to be inefficient, since such transactions are not motivated by maximizing shareholders' wealth, and that these transactions are also most likely structured to maximize tax benefits and use stock rather than cash; also stating that stock-financed mergers do not increase short-term shareholder value). Findings also indicate that the stock of acquiring corporations performed better after a merger acquisition with cash as compared to a stock acquisition. *See* Johnson, *Publicly Traded Stock*, *supra* note 126, at 1367. Professor Johnson contends that if corporate acquisitions are to receive a tax subsidy, it should be designed more carefully to promote worthy acquisitions. *Id.*

169. Brauner, *supra* note 164, at 33–34. In a fairly scathing pronouncement on the efficacy of the reorganization provisions in promoting efficiency, Professor Brauner states that "[t]he actual effect of the reorganization preferences is to provide a poorly designed, unfocused, and arbitrary subsidiary to some participants in certain forms of M&A transactions." *Id.* at 32.

170. *Id.* at 22.

where such transactions are clearly beneficial and the circumstances for achieving these beneficial transactions.[171]

While in theory it may be possible someday to design nonrecognition rules to address market imperfections, the currently available information does not seem to permit this. Until this occurs, using nonrecognition rules to correct market imperfections does not seem to be a viable endeavor.

C. Equity

Tax policy analysts usually evaluate equity under two equity norms: horizontal equity and vertical equity.[172] Horizontal equity is concerned with taxing similarly situated taxpayers in a similar manner.[173] Vertical equity is concerned with taxing differently situated taxpayers in a manner that is appropriately different.[174] As discussed below, horizontal equity notions have been used as a justification for nonrecognition, which this Subpart evaluates.[175]

1. Argument for Nonrecognition

A rationale often given for nonrecognition is that transactions that merely result in a change in form should not be subject to current taxation. This rationale is evident in the Treasury regulations under former section 1002, where the underlying assumption of the nonrecognition rules is stated as "the new property is substantially a continuation of the old investment still unliquidated."[176] Likewise, tax scholars and court opinions have frequently referred to this change in form explanation for nonrecognition.[177]

At bottom, the change in form rationale for nonrecognition seems founded on notions of horizontal equity—that similarly situated taxpayers should be taxed the same.[178] A taxpayer who exchanges property for other property that is different merely in form rather than substance may be viewed as being similarly situated to a taxpayer who continues to hold the same property.[179] Because the continued holder would not be taxed currently on any appreciation in the value of the property, then neither should the taxpayer be

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171. *Id.* at 36, 46 (pointing out that the complexity and multiplicity of factors that explains M&A transactions "exposes further the inadequacy of the stable, but crude and unsophisticated, tax rules that apply to these transactions"). Professor Brauner also determined that the rules do not have a decisive effect in encouraging the stock transactions at which they are aimed. *Id.* at 18, 32. Similarly, after reviewing studies on the effect that tax consequences have on mergers and acquisitions, Professor Shakow concludes that "these studies generally suggest that there is little influence on the occurrence and form of mergers and acquisitions that can be traced to the tax consequences of the transactions." David J. Shakow, *Wither, "C"!*, 45 TAX L. REV. 177, 181–83 (1990) [hereinafter Shakow, *Wither C*]; *see also* Bank, supra note 126, at 30 ("Several studies conducted during the last decade have questioned the degree to which taxes influence the incidence or structure of mergers and acquisitions.").

172. *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. Boskins eds., 1980).

173. *See id.*

174. *See* Brown, *Like Kind*, *supra* note 32, at 711.

175. It should be noted that there is a debate as to whether horizontal equity has any independent significance from vertical equity. *See id.* at 711–12 (discussing this debate).

176. Reg. § 1.1002–1(c).

177. *See, e.g.*, Schlunk, *supra* note 120, at 57 (referring to this as a justification for the corporate reorganization rules); Portland Oil Co. v. Comm'r, 109 F.2d 479, 488 (1st Cir. 1940) (referring to this as the justification for the statutory predecessor to section 351).

178. *See* Jensen, *supra* note 98, at 199 (stating the strongest justification for nonrecognition for like kind exchanges is that a taxpayer that exchanges property for like kind property is in a position that is "similar, though not identical, to the position of a holder of assets that have appreciated or depreciated in value"); *cf.* Schlunk, *supra* note 120, at 57 (discussing this fairness justification for the corporate reorganization rule).

179. *See* Jensen, *supra* note 98, at 204–05 (stating that the "stronger ground" for nonrecognition treatment for like kind exchanges is "taxpayer perception: there is an intuitive appeal to treating the recipient of like-kind property identically with a holder of appreciated property").

taxed who substantially continues her investment by exchanging property for similar property. Thus, the argument runs that nonrecognition results in the equal taxation of similarly situated taxpayers, thereby promoting horizontal equity.

2. Evaluation of Argument for Nonrecognition

The problem with the horizontal equity case for nonrecognition is that nonrecognition rules operate in a second-best world where the tax base deviates from economic income. In determining whether taxpayers are similarly situated for purposes of horizontal equity, ability to pay tax is the guidepost, and tax policy analysts usually treat economic income as the best metric to gauge ability to pay.[180] With economic income as the basis for comparisons, horizontal equity provides no support for nonrecognition.[181]

To illustrate this, assume that on December 31, 2020, three taxpayers (who use the calendar year) each hold an asset with a fair market value of $100,000 and an adjusted basis of $80,000, which had been purchased on January 1, 2020, for $80,000. One of the taxpayers ("seller") sells her asset for $100,000 in cash, realizing and recognizing a gain of $20,000. Another taxpayer ("exchanger") exchanges her asset for a similar asset with a fair market value of $100,000, and because of a nonrecognition rule, does not recognize the $20,000 of realized gain on the exchange. The third taxpayer ("holder") continues to hold her asset and thus does not realize and recognize any gain in 2020.[182] All three taxpayers have economic income of $20,000 in 2020 due to the increase in the value of the property during the year. Using economic income as the comparison, horizontal income does not support nonrecognition treatment for the exchanger.[183] While nonrecognition treatment for the exchanger results in consistent treatment for the exchanger and holder,[184] it causes different treatment for the exchanger and seller.[185] Although it may be contended that the exchanger and seller are not similarly situated, they are the same in terms of economic income. Consequently, horizontal equity as it is usually applied cannot be a justification for nonrecognition.

Nevertheless, nonrecognition for certain transactions may be *perceived* as promoting horizontal equity.[186] That is, in terms of the previous example, the exchanger may be perceived as similarly situated to the holder, and because the holder has no recognized gain, then neither should the exchanger.[187] Applying horizontal equity in the perceptional sense may have value in that taxpayer's beliefs regarding equity may

180. *See* Brown, *Like Kind*, *supra* note 32, at 716; Noël B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319, 364 (1993); Weisbach, *supra* note 90, at 1646.

181. *Cf.* Schenk, *Efficiency Approach*, *supra* note 88, at 519 ("[B]ecause it is impossible to tax equals equally where there is a deviation from the base that cannot be eliminated (in this case, the realization rule)[,] . . . . it is very difficult to say whether any change in a second-best world promotes the equal treatment of equals.").

182. *See* Brown, *Like Kind*, *supra* note 32, at 716 (providing a similar example).

183. *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 after a horizontal equity analysis of a short-against-the-box tax proposal, using economic income as the comparative base).

184. Because of this, horizontal equity also doesn't support recognition treatment for the exchanger, using economic income as the comparative base.

185. *See* Brown, *Like Kind*, *supra* note 32, at 716; *cf.* Weisbach, *supra* note 90, at 1646 ("If [based on economic income] A, B, and C are all 'equals,' but A is taxed differently from C, horizontal equity cannot determine how to tax B.").

186. Other commentators have discussed the significance of perceptional equity. *See* Cunningham & Schenk, *supra* note 180, at 368–69; *see also* Brown, *Like Kind*, *supra* note 32, at 717–18.

187. *See* Brown, *Like Kind*, *supra* note 32, at 718; Jensen, *supra* note 98, at 199, 204–05. In contending that the realization rule is equitable, Professor Chorvat states that Haig and other commentators thought that the income tax should be proportioned based on psychological satisfactions and that "if individuals do not perceive themselves as better off, then they have not enjoyed the satisfaction on which the tax is based. Hence, under a realization model of taxpayer behavior, they should not be subject to tax." Terrence R. Chorvat, *Perception and Income: The Behavioral Economics of the Realization Doctrine*, 36 CONN. L. REV. 75, 116 (2003). This line of analysis could also be extended to recognition.

affect the fairness of the tax system.[188] In addition, taxpayer's perceptions of fairness could impact compliance with the tax laws by affecting taxpayer morale.[189]

The perceptional horizontal equity case for nonrecognition is, however, not clear. Absent a standard metric like economic income, whether two taxpayers are similarly situated can be quite subjective. In this regard, the exchanger in the example above may be viewed as more similarly situated to the seller than the holder, because both the exchanger and the seller *disposed* of their assets, whereas the holder did not. Based on this view of similarly situated, perceptional horizontal equity would support recognition treatment for the exchanger.[190] Moreover, any perceptional equity basis for a nonrecognition provision is weakened to the extent that the relinquished and replacement properties can vary significantly in similarity, such as that which occurs under the like kind rule, section 351, and the corporate reorganization provisions.

If a taxpayer's disposition were involuntary, it arguably should be ignored in determining whether taxpayers are perceived to be similarly situated; thus, an involuntary disposer of property who then acquires similar property may be treated the same as a continued holder of property.[191] This may be the current justification for the involuntary conversion rule[192] as well as for the nonrecognition treatment for shareholders who are involuntary participants in corporate reorganizations,[193] although a perceptional equity rationale for the latter only seems valid if the shareholders ultimately receive stock that is similar to the stock they were forced to dispose of.[194]

D. Administrability

The administrability concerns of valuation and taxpayer liquidity[195] have played a role in the concept of nonrecognition, but generally not in the specific rules. This Subpart evaluates the significance of these policy concerns in designing nonrecognition rules.

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188. *See* Brown, *Like Kind*, *supra* note 32, at 718; Charles E. McLure, Jr., *Comments*, *in* DO TAXES MATTER? 332, 333 (Joel Slemrod ed., 1990); James W. Wetzler, *The Role of Fairness in State Tax Policy*, 47 REC. ASS'N BAR CITY N.Y. 38, 39 (1992).

189. *See, e.g.*, Cunningham & Schenk, *supra* note 180, at 368; Jensen, *supra* note 98, at 205; Charles E. McLure, Jr., *The Budget Process and Tax Simplification/Complication*, 45 TAX L. REV. 25, 57 (1989).

190. *See* Brown, *Like Kind*, *supra* note 32, at 718.

191. *See id.* 719–20.

192. *See id.* at 719–20.

193. *See* Schlunk, *supra* note 120, at 59 n.60. Professor Brauner objects to this fairness argument for nonrecognition treatment for shareholders who were involuntary participants in a merger or acquisition, because the shareholders should have taken this possibility into account when purchasing the stock. Brauner, *supra* note 164, at 15 n.50. Professor Schlunk counters this objection by stating that the same argument can be made against allowing nonrecognition for involuntary conversions under section 1033, given that a possibility of destruction or condemnation is often inherent in property. Schlunk, *supra* note 120, at 79.

194. In this regard, Professor Schlunk would grant nonrecognition treatment to a shareholder who voted against a merger or acquisition, received consideration other than stock in the acquiring corporation, and then promptly reinvested the consideration in stock of the acquiring corporation, if the acquiring corporation is a publicly traded corporation, or perhaps in stock in any corporation that is engaged in the same business as the acquiring corporation, if the acquiring corporation is a privately held corporation. Schlunk, *supra* note 120, at 79–81. Professor Schlunk's proposal would seem to go beyond permitting nonrecognition only for situations where a shareholder experiences an involuntary disposition that ultimately results in the holding of similar property, given the possible dissimilarity of the stock disposed of and acquired under his proposal.

195. While illiquidity is usually referred to as a tax administration concern (*see* Brown, *Complete Accrual*, *supra* note 89, at 1566), it can have economic consequences. *See* Andrew T. Hayashi, *The Quiet Costs of Taxation: Cash Taxes and Noncash Bases*, 71 TAX L. REV. 781 (2018) (providing an economic framework for estimating illiquidity costs).

1. *Valuation*

a. *Argument for Nonrecognition*

A rationale for nonrecognition is that it avoids the valuation difficulties that would otherwise occur in taxing in-kind exchanges of property.[196] If an exchange is taxable, it is necessary to value the property received or relinquished in the exchange in order to determine the amount of recognized gain or loss.[197] Unless the property received or relinquished is readily tradable, valuing property may be costly, subjective, and prone to controversy.[198] Where an exchange receives nonrecognition treatment, valuation is not needed. The legislative history in connection with the early versions of the like kind and corporate reorganizations rules referred to the valuation concerns of taxing thousands of barter transactions and to how these concerns are avoided with nonrecognition treatment.[199] Tax scholars have similarly mentioned the administrative benefit of obviating the need to value the property involved in exchanges qualifying for nonrecognition.[200]

b. *Evaluation of Argument for Nonrecognition*

Avoiding valuation difficulties appears to be a strong basis for nonrecognition for certain in-kind transactions. The administrative costs associated with valuing property that is not readily tradable may render the taxation of exchanges of such property inefficient in that the net tax revenue collected may not justify the valuation expenses involved.[201] Valuation difficulties can lead to lengthy and costly disputes,

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196. *See* H.R. REP. NO. 73-704, at 12–13 (1934), *reprinted in* 1939–1 C.B. (pt. 2) 554, 563–64; Bank, *supra* note 126, at 63–64 (mentioning the valuation difficulties in taxing in-kind exchanges); Kornhauser, *supra* note 96, at 407, 422–23 (stating that it is a widely held view that the like kind rule is a response to the valuation and liquidity problems created by realization); Mehrotra, *supra* note 97, at 29, 58–66 (stating that valuation concerns would render taxing corporate reorganizations impractical; referring to efforts by taxpayers to advocate for corporate reorganization rules in 1920 to relieve closely held corporations of the valuation difficulties in connection with shares transferred in reorganizations; referring to testimony before Congress in connection with the 1921 act, which stated that "in many reorganizations there is no definite, fixed market price for the securities"); Schenk, *Positive Account*, *supra* note 163, at 362 n.26 (noting that valuation concerns appear to be one of the historical bases for the corporate reorganizations rules); Schlunk, *supra* note 120, at 53, 56 (stating that valuation concerns were important in Congress's enactment and retention of the like kind rule; stating that for certain corporate reorganizations, valuation difficulties may exist); *cf.* Sandberg, *supra* note 163, at 100–01 (referring to the widely used argument that the reorganization provisions decrease the need for valuations, but stating that the provisions do not seem to minimize valuation difficulties because of the need for valuations when boot is received and to determine the basis of stock in certain reorganizations); Shaviro, *supra* note 90, at 17 (stating that taxing the gain on like kind exchanges might cause valuation and liquidity problems, but there must be another basis for the rule from a positive standpoint).

197. *See* Bank, *supra* note 126, at 40 (referring to the valuation problems that would occur if mergers were taxed); Hellerstein, *supra* note 97, at 281 (1957) (same).

198. *See* Hellerstein, *supra* note 97, at 281 (mentioning these problems in taxing reorganizations, particularly when non-publicly traded corporations are involved); *cf.* Schenk, *Positive Account*, *supra* note 163, at 365–66 (mentioning these problems in connection with annual valuations if the realization rule were to be replaced with accrual taxation; also mentioning the valuation problems in connection with property and transfer taxes); Leandra Lederman, *Valuation as a Challenge for Tax Administration*, 96 NOTRE DAME L. REV. 1495, 1497–98 (2021) (describing the two main issues posed by valuation: the taxpayer's incentive to take a position opposed to that of the IRS, which would only be challenged if there is an audit (with audit rates being generally low), and if challenged, could lead to costly litigation, in which the IRS may be at a disadvantage; and finding an approach that accurately values assets that are not publicly traded).

199. *See* H.R. REP. NO. 73-704, at 12–13 (1934), *reprinted in* 1939–1 C.B. (pt. 2) 554, 563–64.

200. *See* Hellerstein, *supra* note 97, at 281.

201. *See* H.R. REP. NO. 73-704, at 13 (1934), *reprinted in* 1939–1 C.B. (pt. 2) 554, 564 (stating that the "committee does not believe that the net revenue which could thereby be collected, particularly in these years, would justify the additional administrative expense"); *cf.* Schenk, *Positive Account*, *supra* note 163, at 370 (surmising that

which is evident under current law in connection with charitable deductions, uninsured casualty losses, and the administration of the federal estate and gift taxes.[202] Moreover, the prospects of such disputes may deter taxpayers from engaging in certain in-kind transactions in the absence of nonrecognition treatment.

As an illustration of the valuation problems associated with taxing in-kind exchanges, the recent change to the like kind exchange provision that eliminated personal property from the provision's coverage has created serious valuation difficulties in connection with the trades of player contracts by professional sports teams. As detailed by the IRS, the valuation of player contracts is fraught with difficulties, due to a variety of factors.[203] To avoid disputes between the IRS and professional sports teams that are likely to be highly subjective, complex, lengthy, and expensive,[204] the IRS has recently issued a Revenue Procedure that creates a safe harbor that effectively restores nonrecognition treatment for trades of players contracts.[205]

To be sure, players contracts probably involve unusual valuation difficulties, and certainly not all in-kind exchanges will present valuation problems. For example, where several shareholders transfer non-publicly traded property to a newly formed corporation for non-publicly traded stock, the parties may have already valued the transferred properties in order to determine how much stock they should receive. Assuming that the valuations of the properties are not just in relative terms, they may be accepted by the IRS and courts as determinative of the values of the properties for taxation purposes, given the arms-length nature of the transaction. If so, taxing the transaction should not pose valuation difficulties.[206] Or perhaps some shareholders transfer non-publicly traded property for non-publicly traded stock, and other shareholders transfer cash for the stock, so that the value of the property can be inferred. Moreover, in some situations the property involved in in-kind transactions may be valued for purposes of preparing GAAP-based financial statements.[207] And in some cases, valuation in connection with an in-kind exchange may already be required under the Code, as is the case with contributions of property to a partnership for purposes of section 704(c).[208] Nevertheless, while it appears difficult to ascertain with a degree of precision the situations where taxing in-kind exchanges leads to valuation problems and the resulting costs, it seems reasonable to conclude that valuation difficulties do support nonrecognition for at least some in-kind transactions.

Notwithstanding, the current rules are inconsistent with a valuation-difficulty rationale for nonrecognition. For example, the current rules for corporate reorganizations allow shareholders to receive

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the costs of annual valuation under an accrual system would be quite steep for certain assets, such as closely held stock).

202. *See* Brown, *Complete Accrual*, *supra* note 89, at 1592–93 (referring to cases involving such disputes). It should be noted that unlike these situations where valuation of the properties involved is necessary in light of the operative tax rules, valuation can be avoided for in-kind exchanges by permitting nonrecognition and preserving the realized gain or loss for future recognition via the special basis rules. *See supra* note 33.

203. These include the player's performance, the needs of the particular team as well as of other teams, the player's effect on attendance, when the player will become a free agent, and the particular team's market size. Rev. Proc. 2019–18, 2019–18 I.R.B. 1077.

204. *Id.* at § 2.02(3).

205. *Id.* at § 4. The safe harbor effectively provides nonrecognition, except when cash is received in player trades, by treating the value of player contracts as zero.

206. Similarly, taxpayers involved in an exchange of properties may value the properties relinquished and received. *Cf.* Jensen, *supra* note 98, at 208 (stating that parties in a like kind exchange place values on the properties exchanged). However, valuation of the properties may merely be implicit (*see id.* at 208), and it is be wrong to conclude that the values "are measurable by some common, abstract standard held in the heads of the two parties." Wilson, *supra* note 124, at 968 n.150 (quoting Caroline Humphrey & Stephen Hugh-Jones, *Introduction* to BARTER, EXCHANGE AND VALUE: AN ANTHROPOLOGICAL APPROACH 1, 9 (Caroline Humphrey & Stephen Hugh-Jones eds., 1992)). In other words, while a party to an in-kind exchange may value equally the properties that the party relinquishes and receives, there may be no indication what these values are, nor may there be any assurance that each party is assigning the same values to these properties.

207. For example, this could occur where property is transferred to a corporation or partnership that prepares its financial statements based on GAAP.

208. *See infra* notes 390–391 and accompanying text.

nonrecognition treatment on the transfer or receipt of publicly traded stock, even though the value of the property transferred or received is readily available.[209] Similarly, the vast majority of like kind exchanges today involve qualified intermediaries that sell the relinquished property for cash and then acquire the replacement property for cash.[210] These cash transactions serve to establish the fair market values of the relinquished and replacement properties.[211] Consequently, under the current rules, nonrecognition is afforded to many transactions that pose no difficulties in valuing property for purposes of determining the amount of gain or loss on the transactions.

2. Liquidity

a. Argument for Nonrecognition

A rationale for nonrecognition is that it avoids the liquidity difficulties that would otherwise occur in taxing in-kind exchanges of property.[212] If an exchange results in recognized gain, the taxpayer will be required to pay any tax that is due on the gain. Taxing the taxpayer on an in-kind exchange may create a liquidity problem for a taxpayer, who, unlike in a cash sale, may not have liquid assets arising from the transaction to pay any tax that is due.[213] Of course, the taxpayer may have liquid assets apart from the transaction, but this is not guaranteed. Thus, similar to the installment sale provision,[214] nonrecognition rules respond to the perceived illiquidity of taxpayers who engage in in-kind exchanges.

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209. *See* Schlunk, *supra* note 120, at 56 (stating that for many corporate reorganizations, valuation difficulties are a joke). Commentators have criticized this inconsistency since the 1920s. *See* Mehrotra, *supra* note 97, at 59 (noting this criticism and a suggestion by a commentator that nonrecognition treatment should not apply to reorganizations involving publicly traded stock); *cf.* Bank, *supra* note 126, at 41 (stating that even if valuation is a concern when a taxpayer receives privately held stock, it is less of a concern when a taxpayer receives publicly traded stock); Hellerstein, *supra* note 97, at 281 (mentioning the valuation difficulties of taxing mergers and suggesting that this can be alleviated by limiting the taxation of mergers to situations where publicly traded stock is received).

210. *See* Johnson, *Like-Kind Exchanges*, *supra* note 134, at 477 (referring to the modern like kind real exchange as a "triangular exchange").

211. *See* Kornhauser, *supra* note 96, at 409 (stating that three or more party exchanges involve explicit valuation); Schlunk, *supra* note 120, at 41–42 (stating that in the typical like kind exchange, which is the three-party variety, precise valuation data exists based on the amounts of cash paid); *see also* Johnson, *Like-Kind Exchanges*, *supra* note 134, at 477 ("Valuation is not a serious problem in modern like-kind real estate exchanges.").

212. *See* ALI Project, *supra* note 126, at 157 (stating that nonrecognition treatment for shareholders in corporate reorganizations can be defended on this basis); Bank, *supra* note 126, at 39 (referring to this in the context of the nonrecognition rules for corporate reorganizations); Kenneth P. Brier, *Like-Kind Exchanges of Partnership Interests: A Policy Oriented Approach*, 38 TAX L. REV. 389, 400 (1983); Jensen, *supra* note 98, at 200–01; Kornhauser, *supra* note 96, at 407–08, 422–23 (stating this as one of the theories for the like kind rule; that it is a widely held view that the like kind rule is a response to the valuation and liquidity problems created by realization); Mehrotra, *supra* note 97, at 29 (stating that liquidity concerns would render taxing corporate reorganizations unfair; referring to efforts by taxpayers to advocate for corporate reorganization rules in 1920 to relieve closely held corporations of the liquidity difficulties in connection with shares transferred in reorganizations); Schenk, *Positive Account*, *supra* note 163, at 362 n.26 (noting that liquidity concerns appear to be one of the historical bases for the corporate reorganizations rules); Schlunk, *supra* note 120, at 41, 56 (stating that this is a contributing factor for nonrecognition for like kind exchanges; stating that in certain corporate reorganizations, liquidity difficulties may exist); Note, *supra* note 160, at 853 (referring to commentators who declare that taxing shareholders on the receipt of nonmarketable securities in corporate reorganizations would cause an undue hardship to the shareholders); *cf.* Schenk, *Efficiency Approach*, *supra* note 88, at 516 (in evaluating possible reforms to the realization rule, viewing liquidity as a potential taxpayer cost); Shaviro, *supra* note 90, at 17 (stating that taxing the gain on like kind exchanges might cause valuation and liquidity problems, but there must be another basis for the rule from a positive standpoint).

213. *See* Hellerstein, *supra* note 97, at 281 (referring to the liquidity problems that would occur if mergers were taxed).

214. I.R.C. § 453.

b. Evaluation of Argument for Nonrecognition

It is certainly the case that taxing in-kind exchanges can present liquidity difficulties for some taxpayers, who would experience costs in either liquidating investments, borrowing funds, or diverting cash receipts to pay the tax due, and that nonrecognition treatment can avoid these problems. Moreover, these liquidity difficulties may well deter taxpayers from engaging in certain in-kind transactions. The liquidity difficulties presented by in-kind transactions are similar to those that arise in the context of installment sales of property, where Congress has seen fit to permit the deferred recognition of the gain from most types of installment sales.[215]

Nevertheless, some scholars question the scope or effect of illiquidity for taxpayers in the context of imposing an income tax in the absence of cash transactions. Specifically, in analyzing the realization requirement, commentators assert that taxpayers may be able to plan for, and adjust to, being taxed on gain without regard to dispositions.[216] Moreover, another tax scholar points out that liquidity difficulties caused by taxation in the absence of cash transactions is somewhat nuanced and that in some cases a taxpayer's welfare may be enhanced by requiring her to forego current consumption in order to pay a current tax on savings income.[217] Based on these analyses, some commentators contend that illiquidity concerns do not strongly support the realization requirement.[218]

Despite these assertions, it seems reasonably clear that because some taxpayers would experience costs associated with raising cash in the absence of cash sales to fund tax liabilities,[219] taxpayer illiquidity provides at least some support for the realization requirement.[220] Likewise, it would appear that taxpayer illiquidity would also lend some support for providing nonrecognition treatment to in-kind exchanges.[221] Notwithstanding, as with valuation difficulties, the current nonrecognition rules are inconsistent with an illiquidity rationale given that nonrecognition treatment is available for publicly traded property[222] and given the effective receipt of cash in the case of three-party like kind exchanges.[223]

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215. *Id*.

216. *See* Brown, *Complete Accrual*, *supra* note 89, at 1661–62; Schenk, *Positive Account*, *supra* note 163, at 362.

217. *See* Hayashi, *supra* note 195, at 814 (for taxpayers with certain preferences, current taxation brings them "closer to their optimum, by effectively forcing them to consume less today and save more for the future").

218. *See id.* at 822 (finding that illiquidity costs "are too modest to tip the scales in favor of the realization requirement"); Schenk, *Positive Account*, *supra* note 163, at 365 (stating that "the liquidity argument alone does not explain the realization rule"); Shakow, *Accrual Taxation*, *supra* note 89, at 1167–76 (concluding that liquidity would not be significant problem if the realization rule were to be replaced with accrual taxation).

219. *See* Schenk, *Positive Account*, *supra* note 163, at 363 (referring to the concerns raised by forcing taxpayers to borrow against their assets or hold some assets in liquid form; stating that a more serious concern is where a taxpayer has an undiversified portfolio and whose only option is to dispose of the asset in order to pay the tax).

220. *See* DAVID F. BRADFORD & TREAS. DEP'T TAX POL'Y STAFF, BLUEPRINTS FOR BASIC TAX REFORM 73 (2d ed. rev. 1984); Glogower, *supra* note 95, at 130 (stating that complete mark-to-market taxation would produce liquidity demands that are politically unacceptable).

221. Nonetheless, there are options other than nonrecognition to address liquidity concerns, such as postponing the tax payment with an interest charge. *See* Brauner, *supra* note 164, at 14–15.

222. *See* Schlunk, *supra* note 120, at 56 (stating that there is no illiquidity for many corporate reorganizations). Commentators have criticized this inconsistency since the 1920s. *See supra* note 209; *cf.* Hellerstein, *supra* note 97, at 281 (mentioning the liquidity difficulties of taxing mergers and suggesting that this can be alleviated by limiting the taxation of mergers to situations where publicly traded stock is received); Bank, *supra* note 126, at 41 (stating that even if liquidity is a concern when a taxpayer receives privately held stock, it is less of a concern when a taxpayer receives publicly traded stock).

223. *See* Schlunk, *supra* note 120, at 41 (stating that the strength of the liquidity rationale is considerably doubtful given that a taxpayer can receive nonrecognition treatment in a like kind exchange even though the buyer actually pays cash).

E. The Effect of Other Policies

Besides the familiar trio of tax policy concerns, other policies have played a role in the development of nonrecognition rules. These are examined below.

1. Compromise Between Accretion and Consumption Taxes

As a few tax scholars have contended, the original enactment of the nonrecognition rules may have been due, in part, to a compromise between those who favored an accretion or income tax and those who favored a consumption tax.[224] Because nonrecognition treatment results in no tax when one property is exchanged for another, it is somewhat consistent with a consumption tax, which would similarly treat exchanges of investments as non-taxable events.[225] There are, however, differences between the original nonrecognition rules and a consumption tax, in that the nonrecognition rules were limited to only certain exchanges and did not apply to sales and reinvestments.[226] The latter limitation prevents the nearly indefinite postponement of income taxation, which would have offended accretion tax proponents.[227] Similarly, restricting nonrecognition treatment to only certain property exchanges seems to be due to a concern that taxpayers could postpone indefinitely the income taxation of investment gains by engaging in a barter economy.[228] And the property exchanges selected for nonrecognition treatment are arguably transactions that highlight the weaknesses of the accretion tax model: those in which shareholders continued their investments to some extent,[229] and situations where valuation difficulties were present.[230] Thus, the original nonrecognition rules may have been affected, to a degree, by the competing principles of the accretion and consumption tax models.

While the accretion versus consumption tax debate may have played a role in the original enactment of nonrecognition rules, this does not appear to be a principled basis for continuing the use of nonrecognition rules or proposing reforms thereto.[231] In this regard, the factors arguably used for selecting the transactions eligible for nonrecognition—continuity of investment and valuation and liquidity difficulties—seem to have nothing to do with either the operation of a consumption tax[232] or the alleged virtues of a consumption tax over an income tax.[233] Instead, these factors relate to the traditional policy concerns relevant in the analysis of nonrecognition,[234] and their importance should be considered as part of an overall evaluation of the policies pertaining to nonrecognition, which this Article seeks to do. Consumption tax advocates may have had (and may still have) their thumbs on the scale in creating the nonrecognition rules, but giving some extra weight to pro-nonrecognition factors due to consumption tax sentiments is too vague a criterion in the formulation of sound tax policy.

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224. *See* Bank, *supra* note 126, at 62–63, 66, 73–74; Kornhauser, *supra* note 96, at 432–33.

225. *See* Bank, supra note 126, at 63–64 ("Under the consumption tax model, the imposition of a tax on an exchange of property is premature."); Kornhauser, *supra* note 96, at 432.

226. *See* Kornhauser, *supra* note 96, at 432.

227. *See* Bank, *supra* note 126, at 66. This limitation also may have been due to the perceived difficulty of tracing sale proceeds to subsequent investments. *See* Kornhauser, *supra* note 96, at 432.

228. *See* Bank, *supra* note 126, at 65.

229. *See id.* at 74.

230. *See id.* at 75–77.

231. *But see id.* at 85–86 (arguing for the continued vitality of this compromise in justifying the corporate reorganization rules as a conceptual and political matter).

232. *See* Kornhauser, *supra* note 96, at 432 (stating that the "the exact form of the [nonrecognition] provisions is somewhat arbitrary and inconsistent with a pure expenditure tax. For example, there is no theoretical reason to defer tax on like-kind exchanges but not on other investments.").

233. In this regard, supporters of a consumption tax favor it over an income tax because a consumption tax is neutral on the choice between savings and consumption, while an income tax incentivizes consumption over savings. *See e.g.*, Kornhauser, *supra* note 96, at 429.

234. *See supra* Part III.A.

2. *Corporate Tax Policy*

Corporate tax policy has influenced the development of the nonrecognition rules applying to corporations and their shareholders. This is because the application of nonrecognition rules to transfers by corporations to their shareholders could potentially interfere with certain corporate tax policies.

For example, a broad nonrecognition rule applying to corporate distributions of stock in controlled corporations, in place of the current section 355 requirements for nonrecognition,[235] could lead to the avoidance of the dividend tax. More specifically, consider where a C corporation transfers money to a controlled corporation followed by a distribution of the stock in the controlled corporation to the shareholders of the distributing corporation. The application of a broad nonrecognition rule to this transaction would permit tax-free treatment to an effective distribution of cash (albeit in corporation solution) to the shareholders of the distributing corporation. The shareholders of the distributing corporation could then receive the cash outright by liquidating the formerly controlled corporation in a transaction that would permit them some basis offset. Indeed, these were essentially the facts of *Gregory v. Helvering*,[236] where the U.S. Supreme Court denied nonrecognition treatment to the transaction in an opinion that ultimately led to the business purpose, active business, and no device requirements contained in section 355.

Another effect of applying broad nonrecognition rules to corporate transactions is that the realized gain or loss on property distributed by corporations may be permanently excluded from the base of the corporate income tax. This accounts for the rule that corporations generally recognize gains[237] (and generally also losses on liquidating distributions[238]) on transfers of property to controlling shareholders (and noncontrolling shareholders),[239] even though such transactions seem to have no more significance (from an efficiency-neutrality standpoint[240]) than transfers of property from controlling shareholders to corporations,[241] for which the shareholders generally receive nonrecognition treatment.[242]

These concerns related to the corporate income tax should be an important consideration in crafting nonrecognition rules that apply to corporations and their shareholders.[243] This is not to suggest that the tenets underlying the taxation of corporations and their shareholders should not be altered; however, any change in corporate tax policies should be a part of a comprehensive review of Subchapter C, as opposed to the piecemeal reform of corporate nonrecognition rules.

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235. *See supra* notes 62–67 and accompanying text.

236. 293 U.S. 465 (1935).

237. I.R.C. § 311(b).

238. I.R.C. §§ 336, 337. A liquidating corporation would not recognize gain or loss on a liquidating distribution of property to a parent corporation that satisfies the 80% stock ownership requirements under section 332(b). *See supra* note 74. In addition, a liquidating corporation is prevented from recognizing all or a portion of a realized loss on certain distributions to related persons or distributions of certain property that was acquired in carryover basis transactions. I.R.C. § 336(d).

239. This rule is often referred to as the repeal of the *General Utilities* doctrine, based on the name of the U.S. Supreme Court case that established the doctrine that a distributing corporation does not recognize any gain or loss on the distribution of property to its shareholders. *See* SCHWARZ & LATHROPE, *supra* note 135, at 169.

240. *See supra* Part III.B.2.a.

241. *See* Shaviro, *supra* note 90, at 23.

242. *See supra* notes 40–41 and accompanying text.

243. *Cf.* Shaviro, *supra* note 90, at 23 (stating that corporate tax rules fit a neutrality pattern for nonrecognition to some extent but not as consistently as other rules, because corporate taxation is generally a system that works out the consequences of certain premises, most significantly the separate nature of shareholders and their corporations and that corporate stock is distinct from corporate assets).

F. Summary

Ultimately, the case for having nonrecognition provisions, like many fundamental issues pertaining to tax policy, is debatable. While the analysis in this Part does not firmly resolve this debate, it does suggest that usually the strongest rationales for nonrecognition treatment in a given situation are the valuation and liquidity difficulties that can arise in connection with taxing in-kind transactions, although in limited cases efficiency benefits can be presumed to support nonrecognition. Unlike the empirical uncertainty that often clouds the efficiency rationale,[244] and theoretical flaws in the equity rationale, the aforementioned administrability concerns are solid, supportable reasons for providing nonrecognition treatment for certain in-kind transactions. The most significant downside with providing nonrecognition for certain transactions is the efficiency costs (although uncertain in magnitude) that result when taxpayers structure transactions to take advantage of nonrecognition. In addition, nonrecognition has the potential for interfering with certain policies related to the taxation of C corporations and their shareholders. On the whole, the argument for nonrecognition can be seen largely as an extension of the valuation and liquidity rationales that underlie the realization requirement, and like the realization requirement, nonrecognition engenders efficiency concerns.

The remainder of this Article assumes that valuation and liquidity rationales, tempered by efficiency concerns and corporate tax policy considerations, primarily justify nonrecognition treatment for certain in-kind transactions, although in limited cases, efficiency benefits can be a justification. This Article will use these policies as the principal considerations in developing a standard for suggesting reforms to nonrecognition rules.

IV. A STANDARD FOR DESIGNING NONRECOGNITION RULES

This Part formulates a standard for devising nonrecognition rules based on the policy analysis in the previous part.

A. Generally Discard Similar Replacement Property Factor

While there are exceptions, the efficiency-neutrality rationale for nonrecognition should generally be rejected as lacking in evidentiary support.[245] Similarly, the horizontal equity rationale for nonrecognition should generally be rejected as well, because of its theoretical flaws.[246] As a result, the similar replacement property factor, which is a product of these rationales, should generally be discarded. Except in limited cases (discussed below), there does not appear to be a strong justification for basing nonrecognition on the similarity of the property received to that transferred.[247] Furthermore, nonrecognition should not be limited to the narrow situations where there is sufficient similarity in the properties relinquished and received, because this would still leave unresolved the valuation and liquidity difficulties that would arise in taxing other exchanges.

Nevertheless, some transactions so clearly lack economic significance that it may be presumed that the efficiency benefits from allowing nonrecognition outweigh any efficiency costs.[248] For example, a

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244. Bearing some similarity to this Article's approach, Professor Repetti concluded that the efficiency effects of the income tax are based on "assumptions about theory and empirical analysis that are not supported by the evidence," and "[t]hus, there is no clear case for prioritizing efficiency over equity." James R. Repetti, *The Appropriate Roles for Equity and Efficiency in a Progressive Individual Income Tax*, 23 FLA. TAX REV. 522, 575 (2020).

245. *See* Part III.B.2.

246. *See* Part III.C. This is subject to a possible exception for involuntary conversions. *See infra* note 253.

247. *Cf.* Hellerstein, *supra* note 97, at 286 (the continuing conduct of a similar business should not be a decisive factor in whether gain or loss is recognized in a merger).

248. *Cf.* Shaviro, supra note 90, at 32 (stating that "one can draw plausible inferences about what types of transactions are likely to be more elastic than others").

change in the state of incorporation, despite the business reasons for doing so, seems so insignificant from a non-tax perspective that taxing this event would seem to prevent its occurrence, and thus net efficiency benefits from providing nonrecognition can apparently be presumed. Here, nonrecognition should be permitted regardless of any valuation or liquidity difficulties in taxing the transaction.[249] The application of the wash sales provision, section 1091, is another situation where net efficiency benefits apparently can be presumed. Section 1091 disallows a loss where a taxpayer disposes of stocks or securities and then purchases substantially identical stocks or securities within 30 days before or after the sale.[250] Without this provision, taxpayers would be incentivized to harvest tax losses by selling and immediately repurchasing the same stocks or securities. These tax-motivated transactions would generate Time Two transaction costs, and there would be Time One costs as well because taxpayers would have an incentive to purchase assets that can benefit from harvesting tax losses.[251] For efficiency reasons alone, this quasi-nonrecognition rule should be retained. Thus, for these and some other limited situations,[252] the similar replacement property factor still should be relevant in designing nonrecognition provisions.[253] Accordingly, in designing nonrecognition rules, the similarities or differences in the relinquished and replacement properties should be ignored, unless the properties are either identical or possess a very high degree of similarity.

Generally, eliminating the similar replacement property factor would help to simplify the law.[254] For example, this would obviate the continuity of interest and continuity of business enterprise requirements for corporate reorganizations, as well as the control requirement under section 351, given that these requirements appear based on trying to ensure that transferors' stock holdings following the transaction are similar to their stock or property holdings before the transaction.[255] Likewise, the application of the step-transaction doctrine[256] for corporate reorganizations and corporate formations should be unnecessary to the

249. *Cf.* Glenn E. Coven, *Taxing Corporate Acquisitions: A Proposal for Mandatory Uniform Rules*, 44 TAX L. REV. 145, 191 n.110 (1989) (stating that it would be unsound to tax a simple reincorporation).

250. I.R.C. § 1091(a); *see supra* Part II.A.3.

251. *See* Shaviro, supra note 90, at 47–48.

252. Other situations would be a parent-subsidiary liquidation (s*ee infra* Part V.B.5) and a transfer of assets from a shareholder to a wholly owned corporation (s*ee infra* Part V.B.2). Another situation is the income exclusion that section 305 provides to shareholders where a corporation makes a pro rata distribution of stock to its common shareholders (although this technically does not involve the application of a nonrecognition provision to an exchange of property). I.R.C. § 305(a)–(b). Because such distributions cause no change in the shareholders' proportionate interest in the earnings, assets, or voting power of the corporation, the income exclusion should apply in this situation regardless of whether or not the distributed stock is publicly traded. Otherwise, taxing these stock distributions would almost certainly deter them; for example, it seems extremely doubtful that publicly traded corporations would make pro rata common stock distributions if they were taxable to shareholders, even though these distributions may help with the marketability of a company's stock.

253. For equity rather than efficiency reasons, it may be appropriate to retain the involuntary conversion rule, which permits the elective nonrecognition of gain where a taxpayer experiences an involuntary conversion and uses the conversion proceeds to purchase similar replacement property generally within two years of the conversion. *See supra* Part II.A.2. Valuation and liquidity are not problems in taxing involuntary conversions, given the receipt of the conversion proceeds, and neutrality does not support nonrecognition because the disposition is involuntary and thus will occur regardless of the tax treatment. *See* Shaviro, *supra* note 90, at 46 (stating that nonrecognition treatment "for involuntary conversions is questionable on efficiency grounds"). Yet a taxpayer who involuntarily disposes of property and acquires similar property may be perceived to be similarly situated to a taxpayer who continues to hold property; thus, there is a perceptional horizontal equity case for providing the involuntary disposer with the same tax treatment as the continued holder. *See supra* notes 186–194 and accompanying text.

254. *Cf.* Johnson, *Publicly Traded Stock*, *supra* note 126, at 1367–68 (stating that taxing shareholders on the receipt of publicly traded stock in acquisitive corporate reorganizations would serve to simplify the law).

255. *See infra* notes 308, 321–323 and accompanying text.

256. Very generally, under the step-transaction doctrine, the courts and the IRS will consider only the net results of interrelated transactional steps. *See* SCHWIDETZKY & BROWN, *supra* note 58, at 314–15.

extent that this prevents shareholders from circumventing the continuity of interest and control requirements.[257]

B. Use Difficult-to-Value Property Factor

There is solid support for a factor that looks to whether the relinquished property and replacement properties are difficult to value, given the general difficulty in valuing property transferred and received in in-kind exchanges.[258] Under this factor, an exchange that involves property designed to be readily tradable on an established market (either received or transferred) should not be eligible for nonrecognition. Similarly, an exchange that involves the effective receipt and use of money by the taxpayer—as in multi-party, deferred like kind exchanges—should be ineligible for nonrecognition, given that the cash involved in the transaction allows for value of the exchanged properties to be easily determined.

Of course, under this factor nonrecognition could be denied for other situations that arguably do not pose valuation difficulties even though they do not involve readily tradable property or the effective receipt of cash. As previously discussed, there may well be other situations where taxing in-kind transactions will not cause valuation problems.[259] An approach that prevented nonrecognition for other situations would require certain mechanisms to determine when valuation will not pose unreasonable problems. For example, nonrecognition could be denied where valuations are performed for accounting or other tax reasons,[260] where the parties have specified values as a part of arms-length bargaining that are not just in relative terms, or where appraisals have been obtained in connection with the transaction. Nevertheless, such valuations may still lead to disputes between taxpayers and the IRS;[261] and deciding when nonrecognition would be prevented would also necessitate line drawing that could be fact intensive. Consequently, it seems advisable to avoid this potential messiness and limit the prohibition on nonrecognition to either the presence of property that is readily tradable on an established security market (either received or transferred) or the effective receipt of money.

It should be noted that discriminating between difficult-to-value and easy-to-value property in permitting nonrecognition could result in Time One and Time Two efficiency costs, because of the tax incentive for investing in, or exchanging property for, difficult-to-value property. This arises in the context of permitting nonrecognition to shareholders who receive stock in acquisitive reorganizations, which will be examined in the next Part of this Article.[262]

C. Use Illiquid Property Factor

There is support for a factor that looks to whether the relinquished and replacement properties are illiquid given the perceived illiquidity of taxpayers involved in in-kind exchanges.[263] Whether or not the illiquid property factor is satisfied in a particular situation can be the same as the application of the difficult-to-value property factor, given that nonrecognition will be denied under the latter factor where the taxpayer's relinquished property or replacement property is readily tradable property or the taxpayer has the effective receipt of money; both situations will also provide liquidity to the taxpayer disposing of property. Of course, nonrecognition could also be denied in other situations involving in-kind exchanges, where based on the particular facts, the taxpayer would not have difficulty paying a current tax on the realized gain. However,

257. For an example of the application of the step-transaction doctrine to the control requirement under section 351, see Intermountain Lumber Co. v. Comm'r, 65 T.C. 1025 (1976).

258. *See supra* Part III.D.1.

259. *See supra* notes 207–208 and accompanying text.

260. *See infra* notes 390–394 and accompanying text.

261. In this regard, appraisals may sometimes vary widely and thus lead to disputes. *See* Brown, *Complete Accrual*, *supra* note 89, at 1593.

262. *See infra* notes 336–340 and accompanying text.

263. *See supra* Part III.D.2.

as with the difficult-to-value property factor, it seems advisable to limit the prohibition on nonrecognition to either the presence of property that is readily tradable on an established market (either received or transferred) or the effective receipt of money, to avoid the fact-intensive line drawing that would otherwise be needed.

As mentioned previously, there might be situations involving in-kind exchanges of non-publicly traded property where taxing the transactions will not necessarily cause valuation difficulties.[264] Nevertheless, because non-publicly traded property is illiquid, taxing the transaction may still present liquidity difficulties for the taxpayers.

D. Use Rules That Are Narrowly Tailored to Common Transactional Forms Typically Selected for Significant Non-Tax Reasons

If only the administrative policies of valuation and liquidity were to be used, along with the concomitant difficult-to-value and illiquid property factors, then there could be a simple rule that provided nonrecognition for all in-kind exchanges, as long as the replacement property is other than property that is designed to be readily tradable on an established market.[265] However, there is the serious concern that taxpayers would take advantage of such a nonrecognition rule to engage in barter transactions and other in-kind transactions in lieu of cash sales,[266] thereby generating significant Time Two costs. Time One costs could arise as well, given that the prospect of readily qualifying for nonrecognition would favor investments in growth assets, which can benefit from the realization requirement and nonrecognition treatment, as opposed to yield assets, which have their income taxed irrespective of a disposition. There would also be lost tax revenue, which would need to be raised in other, possibly less efficient ways.[267] With a broad nonrecognition rule like the like kind exchange provision, taxpayers use commercial intermediaries to facilitate swaps of real property, which are otherwise uncommon transactions, to benefit from nonrecognition. If nonrecognition were permitted for all in-kind exchanges of non-publicly traded property, and like section 1031, multi-party exchanges were allowed, an army of commercial facilitators may well arise to assist taxpayers in effectuating in-kind exchanges of such property as a substitute for cash sales to take advantage of nonrecognition treatment.[268] Consequently, the rules need to be designed with these behavioral responses in mind.

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264. *See supra* notes 207–208 and accompanying text.

265. *Cf.* Fred Rogers Fairchild, *Federal Taxation of Income and Profits*, 11 AM. ECON. REV., no. 1 supp., Mar. 1921, at 148, 152 (suggesting that nonrecognition should be extended to all exchanges of property, except for sales for money or for consideration that can be turned into money without a sale, such as a promissory note). With this rule, there could be exceptions that would still permit nonrecognition for exchanges involving publicly traded property where the relinquished and replacement properties are either identical or highly similar. *See supra* notes 248–253 and accompanying text.

266. *See* Kornhauser, *supra* note 96, at 411 (stating that a rule that exempted income from taxation based on illiquidity would create "economic distortion and tax avoidance by encouraging taxpayers to receive income in non-taxable forms"); *cf.* Bank, *supra* note 126, at 71 (stating that the rule generally treating the receipt of property as income prevents the indefinite deferral that could occur through a barter economy); Edward A. Zelinsky, *For Realization: Income Taxation, Sectoral Accretionism, and the Virtue of Attainable Virtues*, 19 CARDOZO L. REV. 861, 872–73 (1997) (stating that while valuation and liquidity concerns do not justify having realization include in-kind exchanges, these must be included so that barter does not have a tax advantage). Under current law, barter exchanges do exist, but they result in taxable transactions for the participants. *See* Rev. Rul. 80–52, 1980–1 C.B. 100.

267. *See supra* Part II.B.2.c.vi.

268. Moreover, if such a broad nonrecognition rule applied to an exchange for consumer durables, the unrecognized gain on the exchange would never be recognized because the replacement property would be consumed. These same concerns should prevent the non-inclusion of property received for the performance of services (although technically these transactions do not involve an exchange of property, and thus are outside of this Article's scope). Under current law, a service provider is generally taxable at the time that property is received in connection with the performance of services. *See* I.R.C. § 83.

To this end, nonrecognition rules for gains and losses should be narrowly crafted so that taxpayers cannot easily and readily structure transactions simply to qualify for nonrecognition.[269] In this regard, both the type of the replacement property and the form of the transaction should be narrowly defined.[270] Moreover, to the extent that nonrecognition transactions are defined in a way that would typically ensure that there are significant non-tax reasons for selecting a particular transactional form, the concern that a particular transaction is chosen for tax reasons is lessened.[271] Consequently, nonrecognition rules for gains and losses should avoid liberal requirements that permit nonrecognition for broad categories of replacement property and flexible transactional forms, and be designed for transactional forms that are typically selected for significant non-tax reasons.[272]

In addition, it seems sensible to further limit nonrecognition treatment to transactions that commonly occur. Valuation and liquidity difficulties are more burdensome to the tax system the more that they occur. Where these administrative difficulties are relatively few in numbers, such as in connection with the estate and gift taxes, the tax system seems to be able to tolerate them. Consequently, nonrecognition treatment seems to be warranted only for common transactions, which in the aggregate would put great strain on the tax administration process, provided that the other criteria for nonrecognition are satisfied. For uncommon transactions involving difficult-to-value and/or illiquid properties that are typically exchanged for significant non-tax reasons, tax administrators and taxpayers should be able to deal with valuation and illiquidity concerns on a case-by-case basis.

It is important to mention that the factor prescribed in this Subpart is not the same conceptually as a similar replacement property factor, nor does it necessarily have the same effect as such a factor. A nonrecognition rule may be narrowly tailored to common transactional forms typically selected for significant non-tax reasons even though the replacement property is dissimilar from the relinquished property. For example, where each of several shareholders transfers a particular asset to newly formed corporation as a part of a single transaction, in exchange for a portion of the corporation's stock, each shareholder goes from holding a direct interest in a particular asset to holding an indirect interest (via the stock received) in a collection of assets. It is quite difficult to see how the relinquished and replacement properties are similar in this situation, but it is not difficult to view the transfer of property to a newly formed corporation as a common, narrowly defined transactional form that is normally selected for significant reasons other than reducing one's taxes. In addition, while an approach that requires similar replacement property may fail to grant nonrecognition to a sizable minority shareholder who alone transfers property to a corporation in exchange for stock, which is the case currently under section 351, nonrecognition treatment could be rationalized under the factor prescribed in this Subpart.

E. Adhere to Corporate Tax Policies

Another important factor in devising nonrecognition rules is to adhere to the policies underlying the separate income taxation of C corporations and their shareholders.[273] These policies include the general imposition of a shareholder-level tax on corporate distributions[274] and of a corporate-level tax on assets that appreciated in value in the hands of the corporation.[275] Because nonrecognition treatment has the potential for interfering with these corporate tax policies, these concerns should be taken into account in developing

269. *See supra* notes 148–149 and accompanying text.

270. *See supra* notes 148–149 and accompanying text.

271. *See supra* note 150 and accompanying text.

272. These considerations should only be used in designing nonrecognition rules that apply to gains and losses. For nonrecognition rules that only apply to losses, such as the wash sales provision (section 1091), these considerations are not appropriate, given that such rules target transactions that are usually tax motivated, and there may be a need to cover flexible transactional forms, as in the case of the wash sales provision.

273. *See supra* Part III.E.2.

274. *See supra* notes 235–236 and accompanying text.

275. *See supra* notes 237–242 and accompanying text.

nonrecognition rules that apply to corporations and their shareholders.[276] I show how this factor might be applied below.

F. Overall Standard for Designing Nonrecognition Rules

This Part has formulated a standard containing five factors that should be used to craft nonrecognition rules: (1) generally ignore the similarities or differences in the relinquished and replacement properties, unless the properties are either identical or possess a very high degree of similarity; (2) presence of difficult-to-value property; (3) presence of illiquid property; (4) use of rules that are narrowly tailored to common transactional forms that are typically selected for significant non-tax reasons; and (5) adherence to corporate tax policies.[277] In designing a nonrecognition rule that applies to gains and losses, either factor 1, 2, or 3 should be satisfied, as either of these factors alone supports nonrecognition, provided that both factors 4 and 5 are satisfied.[278] On the whole, the standard calls for nonrecognition treatment for common, narrowly defined exchanges that are typically selected for significant nontax reasons where the properties exchanged are either difficult to value or illiquid or highly similar, provided that nonrecognition does not interfere with corporate tax policies.

V. USING THE STANDARD TO DESIGN NONRECOGNITION RULES

This Part applies the standard formulated above as a basis for suggesting revisions to certain nonrecognition rules. Before doing so, it is useful to review a few current examples of approaches similar to the recommended approach for designing nonrecognition rules.

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276. While this Article focuses on corporate tax concerns, polices in connection with partnership tax may also play role in designing nonrecognition rules. This is evident in the rules under section 751(b) that can deny a partnership nonrecognition treatment on certain distributions of property to partners in exchange for partner interests. *See supra* note 82. These rules prevent the shifting of ordinary income property among partners. *See* SCHWIDETZKY & BROWN, *supra* note 58, at 213.

277. While not supported by this Article, there may be other standards that can be used to design nonrecognition rules. *See* Charlene D. Luke, Response, *Continuity as the Key to* Reform of Section 355, 69 AM. U. L. REV. F. 39, 41–42 (2019) (in drawing the line between recognition and nonrecognition based on continuity, a "list of factors relevant to analyzing continuity would include the presence of cash or cash substitutes, the relatedness of transferor(s) and transferee(s), continuing access to or control of the asset by the transferor after the change, the voluntariness of the change, and the similarity or fungibility of the asset(s) held before and after the change").

278. It should be mentioned that designing a nonrecognition rule so that it satisfies both factors 1 and 4 is not inconsistent. A transaction can involve relinquished and replacement properties that are highly similar, and thus be lacking in economic significance, while at the same time be motivated by significant non-tax reasons. An example is the reincorporation of an existing corporation in a different state. Despite business reasons for a reincorporation, the transaction seems so lacking in economic significance that it seemingly would not occur if it were taxed, and thus significant Time Two benefits from providing nonrecognition can apparently be presumed. And the Time Two costs due to permitting nonrecognition seem minimal, given that it is quite unlikely that a reincorporation would occur to take advantage of nonrecognition treatment.

For nonrecognition rules that only apply to losses, such as the wash sales provision (section 1091), factor 4 should not apply, given that such rules target transactions that are usually tax motivated and there may be a need to cover flexible transactional forms, as in the case of the wash sales provision.

A. Current Examples That Are Similar to the Recommended Approach for Designing Nonrecognition Rules

Under current law, there are a few examples of approaches for devising rules similar to that recommended by this Article. While usually not referred to as a nonrecognition rule, the installment sale provision, [279] section 453,[280] is consistent with an application of the prescribed factors for designing nonrecognition rules. Although valuation concerns are not a driver of the provision, perceived illiquidity certainly is. [281] Installment sales are a fairly narrow type of common transaction that seems typically selected for significant non-tax reasons.[282] While not involving what most would consider a true property exchange, it is worth noting that the property received, installment obligations, is quite dissimilar from the property sold; similarity of the property is obviously not a factor for deferred recognition under the provision.[283] It should be noted that there are differences between section 453 and the provisions typically referred to as nonrecognition provisions. One difference is that the replacement property in a nonrecognition transaction would receive a fair market value basis under section 1014 upon death, eliminating any gain or loss that went unrecognized, whereas unrecognized installment gain is income in respect of a decedent.[284] Another difference is the unrecognized gain on an installment sale is recognized as payments are received according

279. In this regard, Professor Schlunk views section 453 as a type of nonrecognition rule, because it has the same effect as a typical nonrecognition rule, given that gain is taxed only when cash is received. Schlunk, *supra* note 120, at 37–38.

280. I.R.C. § 453.

281. *See* Schlunk, *supra* note 120, at 44 (viewing the installment sale rule as providing nonrecognition treatment on the basis of liquidity concerns alone, as opposed to liquidity and valuation concerns, the purported grounds for the like kind rule). Consistent with this Article's approach, under section 453, the seller's receipt of an evidence of indebtedness that is designed to be readily tradable on an established securities market is treated as receipt of payment, which thereby triggers the recognition of gain. I.R.C. § 453(a), (c), (f)(4)–(5).

282. Professor Schlunk speculates, however, that the seller is far more likely to insist on installment sales in order to defer paying tax on the gains, as compared to the buyer insisting on such a sale. Schlunk, *supra* note 120, at 38.

283. Similarly, the treatment of the assumption of liabilities under the corporate nonrecognition rules is also consistent with this Article's approach. Under section 357, the assumption of a transferor's liabilities in a section 351 transaction (*see supra* Part II.B.1) or a section 361 transaction (*see supra* notes 55–56 and accompanying text) is generally not treated as money received by the transferor, and therefore will not trigger the recognition of any realized gain. *See* I.R.C. §§ 357(a), 351(b), 361(b). Thus, a transferor can still receive nonrecognition where liabilities are assumed in a section 351 or section 361 exchange. Even though the transferor has effectively cashed out to the extent of the liabilities assumed and therefore has changed the nature of its holdings, liquidity concerns support nonrecognition treatment here, given that no actual cash is received. *See* Brauner, *supra* note 164, at 61 (stating that the rationale for generally treating the assumption of liabilities in a corporate reorganization as a nonrecognition event is that "taxation will cause undue hardship on taxpayers since they received no cash in the transaction"). Valuation concerns also support nonrecognition, because if the assumption of liabilities were treated as boot, the property relinquished or received in the exchange would generally need to be valued to determine the amount of realized gain on the exchange. *See infra* notes 314–315 and accompanying text. Furthermore, section 357 contains an anti-abuse rule to prevent taxpayers from structuring transactions to take advantage of the provision. I.R.C. § 357(b) (the assumption of liabilities is treated as money received by the transferor if the principal purpose was to avoid federal income tax or was not a bona fide business purpose). This anti-abuse rule is consistent with this Article's recommendation to design nonrecognition rules so that taxpayers cannot easily structure transactions simply to qualify for nonrecognition. It should be noted that not all nonrecognition rules treat the assumption of liabilities as non-boot. For example, the like kind rule (*see supra* Part II.A.1) treats the assumption of a transferor's liabilities as money received, although there is a rule that permits a transferor to net liabilities assumed by the transferor against the transferor's liabilities assumed by the other party for purposes of determining the amount of boot received by the transferor in the exchange. I.R.C. § 1031(d); Reg. § 1.1031(d)–2.

284. I.R.C. § 691(a)(4)–(5).

to a payment schedule (although this can be long delayed),[285] whereas there is no schedule for recognizing the unrecognized gain in a nonrecognition transaction.

Another example similar to this Article's approach for crafting nonrecognition rules is section 731,[286] which governs distributions by a partnership to its partners. On a distribution of money, a partner recognizes gain to the extent the money distributed exceeds the partner's adjusted basis in her partnership interest.[287] On the other hand, distributions of property are generally nonrecognition events to both the partnership and the partners.[288] The rules for marketable securities are complex, but generally such securities are treated as money under the distribution rule, and thus their distribution can result in recognized gain to a partner when distributed.[289] As stated by Congress, marketable securities are nearly as easy to value and as liquid as money, and not treating marketable securities the same as money under the partnership distributions rule would cause taxpayers to choose marketable securities for tax reasons as opposed to economic reasons.[290] Thus, valuation and liquidity, along with concerns over Time Two costs, figure prominently in crafting this nonrecognition rule.

A recent example of an approach akin to that of this Article is a Revenue Procedure applicable to trades of player contracts, which was issued in response to the 2017 change in the tax law that eliminated personal property from the coverage of the like kind exchange provision, section 1031.[291] Prior to this change, trades of player contracts would ordinarily receive nonrecognition treatment under section 1031. With the elimination of nonrecognition treatment by the 2017 tax act for trades of player contracts and other personal property exchanges, teams trading player contracts would be required to value the contracts for purposes of recognizing any gain or loss. As discussed by the IRS, valuing such contracts is fraught with difficulties due to several factors.[292] To avoid these difficulties, Revenue Procedure 2019–18 creates a safe harbor that effectively restores nonrecognition treatment for trades of player contracts by professional sports teams.[293] Thus, in terms of the standard prescribed by this Article, the difficulty in valuing the property received or relinquished in these exchanges figures prominently in the IRS's decision to provide an effective nonrecognition rule for this situation. Perhaps also of importance is that trades of player contracts are a common type of narrowly defined transactional form that is selected for significant nontax reasons. Consequently, there appears to be little concern that professional sports teams will structure player trades to take advantage of the effective nonrecognition treatment. On the whole then, the rule provided in the Revenue Procedure seems based on considerations very similar to those recommended by this Article.[294]

B. Revisions to Specific Nonrecognition Rules

This Subpart discusses revisions to some specific nonrecognition rules in light of the standard formulated by this Article.

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285. See Schlunk, *supra* note 120, at 38. The amount of the payments that is likely to be received on an installment sale is known, except in the case of contingent payment sales. *See id.* at 38 n.24.

286. I.R.C. § 731; *see supra* Part II.C.2

287. I.R.C. § 731(a)(1).

288. I.R.C. § 731(a)–(b).

289. I.R.C. § 731(c).

290. H.R. REP. NO. 103-826, pt. 1, at 187–88 (1994).

291. *See supra* note 29.

292. *See supra* note 203.

293. *See supra* note 205.

294. While contracts for different players may be viewed as similar property, this was not mentioned by the IRS in the Revenue Procedure as a reason for crafting the rule.

1. Like Kind Exchange Rule

An application of the standard developed by this Article for designing nonrecognition rules indicates that section 1031, the like kind exchange rule,[295] should be repealed. For starters, the provision violates the prescription of having narrowly tailored rules that are designed to accommodate common transactional forms typically selected for significant non-tax reasons. Section 1031 applies to nearly any exchange of real property for other real property, and thus it can apply to broad range of transactions that, aside from the tax advantages, may well be quite uncommon. Because of the rule's latitude, taxpayers are able to engineer multi-party transactions where they can achieve nonrecognition by effectively selling one piece of realty and investing the proceeds into another piece of realty.[296] Thus, the like kind exchange rule appears to create significant Time Two costs by incentivizing taxpayers to reinvest the proceeds of real estate dispositions into other real property rather than other investments or business assets.[297]

Moreover, because the typical like kind exchange is a multi-party transaction where the relinquished property is effectively sold for cash and the proceeds reinvested in the replacement property, the value of the relinquished and replacement properties can be measured with precision, and consequently the difficult-to-value factor does not support nonrecognition treatment.[298] For the same reason, the illiquid property factor does not support nonrecognition treatment because the taxpayer disposing of the property should be able to pay any tax that is due by using some of these cash proceeds rather than investing them in the replacement property.

Instead of repeal, one could consider making certain reforms to the like kind rule that could limit the Time Two costs and have the provision only apply to situations where the properties involved are difficult to value and lack liquidity.[299] For example, the ability to use qualified intermediaries could be eliminated, and three-party exchanges[300] could be disallowed as well. Thus, only two-party exchanges of non-publicly traded property would be permitted, and given the frictions involved in such transactions, this would seem to ensure that nonrecognition is only permitted for narrow circumstances that typically involve significant nontax reasons, and where the properties exchanged are difficult to value and illiquid. However, because it would seem quite rare that taxpayers would want to engage in such two-party exchanges,[301] these transactions do not seem to be common and thus seem outside of the prescribed standard for nonrecognition treatment.[302] Moreover, in connection with such an approach, there would probably need to be a timing rule so that taxpayers could not turn a disallowed three-party exchange into a covered two-party exchange by having one of the exchanging parties acquire for cash the replacement property desired by the other party a fairly short time before the exchange.[303] For these reasons, it does not seem worth the legislative and administrative effort to revise section 1031 in this manner.[304]

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295. *See supra* Part II.A.1.

296. *See supra* note 32.

297. *See supra* notes 147–148 and accompanying text.

298. *See* Kornhauser, *supra* note 96, at 409 (stating that three or more party exchanges involve explicit valuation); *See* Johnson, *Like-Kind Exchanges*, *supra* note 134, at 477 ("Valuation is not a serious problem in modern like-kind real estate exchanges. In a triangular exchange, the purchaser and taxpayer bargain over the price and the purchaser deposits the agreed-on price with the hired third-party broker.").

299. In theory, it may also be possible revise the like kind rule to increase the Time Two benefits by requiring that like kind replacement property be very highly similar to the relinquished property, but in practice it is not clear how to do this. *See supra* note 131 and accompanying text.

300. *See* Rev. Rul. 77–297, 1977–2 C.B. 304.

301. *See* Johnson, *Like-Kind Exchanges*, *supra* note 134, at 477 (noting the rarity of natural barters because parties rarely want each other's property).

302. *See supra* text following note 272.

303. *Cf.* Johnson, *Like-Kind Exchanges*, *supra* note 134, at 477 (stating that if two-party like-kind exchanges were still nontaxable, it would be very difficult to police such transactions to determine the use of hidden cash by purchasers).

304. *See id*. at 477 (reaching the same conclusion for similar reasons).

Despite the suggested repeal of section 1031, there may be situations where narrow rules permitting nonrecognition for property exchanges are appropriate in light of the standard prescribed by this Article. A good example of this are trades of players contracts, with respect to which the IRS has recently crafted an effective nonrecognition rule because of the difficulty in valuing such contracts for purposes of recognizing gain or loss.[305] There may be other isolated situations where exchanges of difficult-to-value or illiquid property occur commonly and for significant nontax reasons, for which narrow nonrecognition rules seem appropriate.

2. *Corporate Formations and Transfers to Controlled Corporations*

An application of the standard for nonrecognition developed in this Article suggests two major changes to section 351, which governs corporate formations and other transfers to controlled corporations.[306] First, because the standard calls for generally discarding the similar replacement property factor, nonrecognition under section 351 should generally not require that the transferors of property be in control of the transferee corporation immediately after the exchange.[307] In this regard, the control requirement appears to try to ensure that the transferors' stock holdings following the exchange are sufficiently similar to their previous holdings in the transferred property.[308] Second, in light of the difficult-to-value and illiquidity factors, nonrecognition treatment should generally not apply where either the stock received or property transferred is designed to be readily tradable on an established market.[309] However, it is appropriate to permit

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305. *See supra* notes 291–294 and accompanying text.

306. *See supra* Part II.B.1.

307. See *infra* text accompanying note 310 for a limited situation where a control requirement would still be used.

308. *Cf.* Shaviro, *supra* note 90, at 52–53 (referring to Professors Bittker and Eustice's suggestion that this may be a way of only permitting nonrecognition where the change in assets owned indirectly by the contributing shareholders after the transfer is not too great as compared to the assets owned directly before the transfer; pointing out, however, that because the control test ignores shifts in ownership within the control group of shareholders, the author does not have a good efficiency explanation for the test). One commentator argues that Congress included the 80% control requirement to prevent vendors from receiving tax-free treatment when providing goods and supplies to existing corporations in exchange for readily marketable stock. Ronald H. Jensen, *Of Form and Substance: Tax-Free Incorporations and Other Transactions Under Section 351*, 11 VA. TAX REV. 349, 398–99 (1991). Without this requirement, a vendor could sell goods to a publicly traded corporation in exchange for stock in lieu of cash and not recognize any gain or income. *See id.* at 398. This explanation for the 80% control requirement, however, does not explain why the control requirement also applies on the formation of the corporation. *See id.* at 399–402 (acknowledging this and contending that the control requirement was probably intended not to apply to initial incorporations). Nevertheless, while preventing tax-free transactions for publicly traded stock appears to be a valid reason for the 80% control requirement, this reason for the control requirement is mooted under this Article's suggestion to deny nonrecognition treatment under section 351 where a transferor receives publicly traded stock. *See infra* note 309 and accompanying text.

It is also worth mentioning that section 721 does not have a control test for contributions to partnerships, and it is not apparent why the rule should be different for corporations.

309. *See* Johnson, *Publicly Traded Stock*, *supra* note 126, at 1368 (proposing that publicly traded stock received in section 351 transactions be treated as boot). For this and other situations where nonrecognition treatment is denied for property that is designed to be readily tradable on an established market, there would need to be anti-abuse rules for determining what property is so designed. In this regard, the rules under the Treasury regulations under section 453 contain rules that could be used for this purpose. Reg. § 15A.453–1(e); *see also* Fred B. Brown, *Proposing a Single, Simpler Test for Cash Equivalency*, 71 TAX LAW. 591, 611–14 (2018) (discussing these rules).

Besides being supported by the difficult-to-value and illiquidity factors, denying nonrecognition treatment to shareholders who receive publicly traded stock in section 351 transactions is necessary to prevent parties from achieving nonrecognition treatment in a publicly traded corporation's acquisition of another corporation through the use of a section 351 transaction. Johnson, *Publicly Traded Stock*, *supra* note 126, at 1369. As discussed in Part V.B.3.b, this Article recommends that shareholders be denied nonrecognition treatment on the receipt of publicly traded stock in acquisitive reorganizations.

nonrecognition where a shareholder transfers publicly traded property to a wholly-owned corporation (or perhaps a corporation in which the transferor has a large, controlling interest, such as at least 80 percent); this is because such a transaction so clearly lacks non-tax significance that net efficiency benefits from providing nonrecognition can be presumed.[310] Aside from these needed revisions, section 351 satisfies the standard developed by this Article, as it provides a narrow rule that is tailored to common transactional forms typically selected for significant non-tax reasons.[311] With these changes, a transfer of non-readily tradable property to a closely held corporation in exchange for a minority or controlling stock interest would receive nonrecognition treatment, while the same transfer to a publicly traded corporation in exchange for the corporation's publicly traded stock[312] would not.[313]

In light of the difficult-to-value factor, the treatment of boot received in a section 351 transaction and other nonrecognition transactions should be reconsidered. Currently under section 351 and other nonrecognition provisions, a taxpayer who receives boot in a transaction otherwise qualifying for nonrecognition recognizes any realized gain to the extent of the amount of the boot received.[314] Because this rule uses the amount of realized gain, the value of the property received or relinquished in the exchange may need to be determined,[315] unless it is clear that the amount of realized gain exceeds the amount of boot received, in which case the taxpayer will recognize the amount of the boot as recognized gain. Determining the value of the properties involved in an exchange may be difficult in the absence of readily available market values. A possible solution would be to revise the boot recognition rules so that a taxpayer receiving boot in a transaction otherwise qualifying for nonrecognition would recognize an amount of gain equal to

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310. *See supra* notes 248–253 and accompanying text.

311. In this regard, the current prohibition on nonrecognition treatment for transfers to investment companies contained in section 351(e)(1) should be retained. This provision was enacted to prevent nonrecognition treatment where investors transfer appreciated securities to a corporation in order to diversify their holdings while avoiding a current tax on the gains—what would be a tax-motivated use of section 351. *See* BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 3.15[1] (7th ed. 2017). Nevertheless, revising section 351 to generally deny nonrecognition on transfers of publicly traded property will obviate the need for applying section 351(e)(1) in many cases, and thus avoid the complexity that this provision entails in these cases. *Cf.* Reg. § 1.351–1(c) (providing detailed rules on determining whether a transfer to an investment company occurs); SCHWIDETZKY & BROWN, *supra* note 58, at 42 (discussing these rules).

312. Where there is a transfer of non-readily tradable property to a publicly traded corporation in exchange for the corporation's publicly traded stock and stock in a class that is not publicly traded, only the publicly traded stock would be treated as boot, resulting in the recognition of realized gain to the extent of this boot. I.R.C. § 351(b)(1); *see also supra* note 41 and accompanying text. Where a shareholder receives only publicly traded stock, the shareholder should be able to recognize any realized loss. *Cf.* Johnson, *Publicly Traded Stock*, *supra* note 126, at 1368 (proposing that a shareholder of a target corporation who only receives publicly traded stock and other boot in a reorganization transaction should be able to recognize any realized loss). This is because such a transaction is in substance a sale. *See id.* at 1368.

313. It should be noted that this measure could generate Time One efficiency costs by advantaging investments in non-publicly traded corporations over publicly traded ones, as well as Time Two efficiency costs by advantaging transfers of property to non-publicly traded corporations over publicly traded ones. However, the prospect of benefitting from nonrecognition under section 351, while valuable, does not seem to present concerns of significant Time One and Time Two efficiency costs, given the other tax and non-tax differences between publicly traded and non-publicly traded corporations. *See infra* notes 339–340 and accompanying text.

Nonrecognition treatment under section 1032 for a corporation issuing its stock in exchange for money or other property should remain the same, even if the issued stock is publicly traded. Unlike other situations where nonrecognition rules currently apply, a corporation's receipt of money or property for its stock should not even be treated as a realization event in concept, because the amounts received are offset by the corporation's obligations to make payments in connection with the issued stock in the future. *See* Johnson, *Publicly Traded Stock*, *supra* note 126, at 1369 n.48. This is similar to a borrower not having income on borrowing money because of the obligation to repay the funds. *See id.*

314. *See supra* notes 33, 41, 54, 70 and accompanying text.

315. *See* Jensen, *supra* note 98, at 209 (stating that where boot is received in a like kind exchange, valuation is necessary so that gain can be determined); Kornhauser, *supra* note 96, at 409 (same).

the amount of the boot received, regardless of the amount of realized gain or loss on the transaction.[316] While this could result in the amount of the recognized gain exceeding the amount of the realized gain, any excess recognized gain would increase the taxpayer's basis in the qualifying property received in the exchange (e.g., stock of the transferee corporation in a section 351 transaction)[317] and thus lower the amount of the gain (or increase the amount of the loss) that is preserved in such property.[318]

3. Acquisitive Corporate Reorganizations

An application of the standard for nonrecognition formulated by this Article suggests that a few major changes should be made to the rules applying to acquisitive corporate reorganizations.

a. Definition of Acquisitive Reorganizations

Because the standard calls for narrowly tailored rules geared to common transactional forms that are typically selected for significant non-tax reasons, the revised corporate reorganization provisions should continue to require certain types of transactions as a prerequisite for nonrecognition.[319] And in this regard, the types of acquisitive transactions listed under current law[320] are those that appear to satisfy these criteria, as they are fairly narrowly drawn and seem to occur commonly and for significant business reasons. However, with the similar property replacement factor generally discarded, the continuity of interest

316. Another possibility is to go in the opposite direction and use the basis-recovery method that is used for contributions to a partnership, under which boot received is generally not taxable, except to the extent it exceeds the partner's adjusted basis in the partnership interest. *See* I.R.C. § 731(a)(1); SCHWIDETZKY & BROWN, *supra* note 58, at 49. Under this approach, the boot received in a section 351 transaction would only be taxable to the extent that the boot exceeds the transferor-shareholder's basis in the stock. However, the use of a basis recovery method in the section 351 context would require rules to guard against disguised sales like those that exist in Subchapter K, because taxpayers would be tempted to structure cash sales as nonrecognition transactions. *Cf. id.* at 242–49 (discussing the partnership disguised sales rules contained in section 707(a)(2)(B) and referencing other disguised sales rules in sections 704(c)(1)(B) and 737). Because of the complexity that this would add to Subchapter C, the use of a basis-recovery method for taxing boot under section 351 does not seem advisable.

317. *See supra* note 41.

318. Another situation where valuation is currently necessary in connection with a qualifying section 351 transaction is the receipt by the shareholder of more than one class of stock in the transaction—for example, common and preferred stock. Where this occurs, it is necessary to allocate the basis of the property transferred by the shareholder (as adjusted under section 358) between the stock of different classes, based on their relative fair market values. Reg. § 1.358–2(b)(2). While this may create some valuation difficulties, several considerations may mitigate these concerns. *See infra* note 377 and accompanying text. In addition, valuation in connection with a section 351 transaction may also be necessary to determine whether section 362(e)(2) applies, and if it does, the effect of this provision. Under section 362(e)(2), if the aggregate basis that a corporation would normally take in the properties transferred by a shareholder under section 362(a) (*see supra* note 42) exceeds the aggregate fair market value of these properties when transferred to the corporation, the corporation's aggregate basis in the properties is limited to their aggregate fair market value, unless the corporation and shareholder jointly elect to limit the shareholder's basis in the stock received for the properties to its fair market value. I.R.C. § 362(e)(2). Consequently, there will be situations where valuations will be needed for purposes of the provision, although this may not be the norm given that most assets tend to appreciate in value.

319. *Cf.* Shaviro, *supra* note 90, at 58 (stating that some limitation on the availability of nonrecognition for corporate acquisitions may be necessary to prevent the application of nonrecognition to sales and exchanges generally). Nevertheless, limiting nonrecognition treatment to certain corporate acquisitions would still produce some Time Two costs because some taxpayers will change their preferred transactions to satisfy the terms of transactions qualifying for nonrecognition treatment. *See id.* Moreover, because nonrecognition treatment will only be available where stock is given as consideration in the qualifying transaction (as discussed in Part V.B.3.b), taxpayers will have a tax incentive to use stock rather than cash in these transactions. *See* Brauner, *supra* note 164, at 32.

320. *See supra* notes 43–45 and accompanying text.

requirements contained in both the common law and the statutory definitions[321] should be deleted. Likewise, the continuity of business enterprise requirements[322] should be eliminated. As discussed previously, these continuity requirements are apparently aimed at ensuring that the replacement property received by the target shareholders, i.e., the stock in the acquiring corporation, bears some similarity to the target stock relinquished by these shareholders.[323] Eliminating the continuity of interest and business enterprise requirements will help to simply the law.[324] It will also provide more neutral tax treatment for different forms for conducting transactions, given that the continuity of interest requirement varies for different types of acquisitive reorganizations.[325]

Thus, the definition of an acquisitive reorganization under the revised rules could generally follow the current rules, except for the continuity of interest and continuity of business enterprise requirements.[326] Accordingly, types A, B, and C acquisitive reorganizations can be defined more simply, respectively, as (1) a statutory merger; (2) an acquisition by one corporation of a controlling stock interest in another corporation, and (3) an acquisition by one corporation of substantially all of the assets of another corporation, followed by the liquidation of the first corporation.[327]

b. Shareholder Consequences

Based on the difficult-to-value and illiquidity factors, shareholders in acquisitive reorganizations should recognize gain where they receive stock that is designed to be readily tradable on an established market,[328] because such readily tradable property is neither difficult to value[329] nor illiquid.[330] More specifically,

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321. *See supra* notes 43–45, 50–51 and accompanying text.

322. *See supra* note 49 and accompanying text.

323. *See supra* notes 103–105 and accompanying text.

324. *Cf.* Johnson, *Publicly Traded Stock*, *supra* note 126, at 1367–68 (contending that taxing publicly traded stock that is received in acquisitive corporate reorganizations would simplify the law by removing the motive and engine for the complexity of the law on acquisitive reorganizations); Shakow, *Wither C*, *supra* note 171, at 183 (stating that if corporate reorganizations can be made taxable, "the practical complexity of corporate tax practice would be greatly reduced").

325. *See* Hoffer & Oesterle, *supra* note 105, at 1096–98; Shaviro, *supra* note 90, at 57 & n.207 (noting the "erratic, patchwork nature" of the continuity of interest rules as applied for different forms of acquisitive reorganizations).

326. See *supra* notes 43–45 and accompanying text for a description of the current rules.

327. As under current law, the revised rules should permit triangular versions of these acquisitive reorganizations, i.e., where the stock of the acquiring corporation's parent corporation is used to acquire the assets or stock of the target corporation. *See supra* note 45.

328. *See* Hellerstein, *supra* note 97, at 281–84 (proposing that nonrecognition be eliminated for reorganizations in which shareholders receive either "stock traded on an exchange or in the over-the-counter market if an adequate market exists for the sale of the stock received" (emphasis omitted)); Johnson, *Publicly Traded Stock*, *supra* note 126, at 1368 (proposing that publicly traded stock be treated as boot for purposes of taxing shareholders in acquisitive reorganizations); Mehrotra, *supra* note 97, at 59 (noting a suggestion in 1921 by a commentator that nonrecognition treatment should not apply to reorganizations involving publicly traded stock). As noted previously, there would need to be anti-abuse rules for determining property that is designed to be readily tradable on an established market. *See supra* note 309.

329. While publicly traded stock is easy to value, a few commentators have raised the concern that market value of a company's stock after a reorganization may be artificially inflated as a result of a temporary and excited market. *See* Bank, *supra* note 126, at 76–77; ROBERT H. MONTGOMERY, INCOME TAX PROCEDURE 1920, at 367 (1920). If this were truly a concern, a possible solution would be to delay the valuation of the stock to a time when the market for the stock has stabilized. In this regard, the federal estate tax provides for an alternate valuation date to address fluctuations in the value of assets. I.R.C. § 2032.

330. *See* Crockett, *supra* note 167, at 18–19 (stating that because of the liquidity of publicly traded stock, shareholders can sell some of the stock to pay the tax on any gain realized); Hellerstein, *supra* note 97, at 281–82 (stating that the valuation and liquidity problems supporting nonrecognition would be removed if shareholders were taxed on the receipt of publicly traded stock); Johnson, *Publicly Traded Stock*, *supra* note 126, at 1365 (stating that

nonrecognition treatment should be denied where shareholders exchange stock in a corporation (whether publicly traded or non-publicly traded) for stock in a publicly traded acquiring corporation.[331] More technically, the receipt of publicly traded stock should be treated as boot,[332] which would result in shareholders recognizing any realized gain to the extent of the publicly traded stock and any other boot received in the transaction.[333] On the other hand, nonrecognition treatment should be permitted where shareholders exchange stock in non-publicly traded corporations for stock in other non-publicly traded

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publicly traded stock received by shareholders in acquisitive corporate reorganizations is easy to value and liquidate). It should be pointed out that in its study of the corporate reorganization rules, the American Law Institute decided against taxing shareholders on the receipt of readily marketable stock. *See* ALI Project, *supra* note 126, at 163. One of its reasons for doing so is that the amount of the acquiring corporation's stock issued in the transaction may be so large relative to normal trading volume that it may not be readily marketable. *See id.* at 160–61. According to the American Law Institute, taxing the receipt of readily marketable stock might require something like an organized underwriting effort to raise the needed cash. *Id.* While this may be the case, it would nevertheless seem that there could be a mechanism to raise the funds to pay the tax. Moreover, where this proves cumbersome, the government could effectively lend taxpayers the needed cash to pay the tax. *Cf.* Schlunk, *supra* note 120, at 56 (stating that where taxing shareholders on a reorganization presents liquidity concerns, mechanisms could be enacted that would permit Treasury to effectively lend cash to taxpayers).

Taxing shareholders on the receipt of publicly traded stock may also reduce Time Two costs, because nonrecognition treatment for such property may encourage parties to structure corporate acquisitions for publicly traded stock rather than cash, the former being a substitute for cash. *Cf.* Johnson, *Publicly Traded Stock*, *supra* note 126, at 1366 (pointing out that a tax system that does not tax substitutes for cash is easy to avoid; stating that taxpayers damage themselves by avoiding tax).

331. *See* Johnson, *Publicly Traded Stock*, *supra* note 126, at 1368 (proposing that publicly traded stock in an acquisitive reorganization be treated as boot). Taxing shareholders on the receipt of publicly traded stock in corporate reorganizations may encourage the use of acquisition techniques that avoid having the target shareholders receiving such stock. For example, an acquiring corporation could transfer its publicly traded stock to the target corporation in exchange for a controlling interest in the target corporation, a transaction which would be nontaxable to both the target corporation and the acquiring corporation pursuant to section 1032. *See id.* at 1369. Such a transaction, however, may be undesirable to the target shareholders, because they would end up holding a minority interest in a non-publicly traded corporation. *See id.* Another possibility would be to use an Up-C structure in a corporate acquisition. *See* Gregg D. Polsky & Adam H. Rosenzweig, *The Up-C Revolution* 34 & n.96 (Oct. 2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2851872 (describing the use of an Up-C structure in an acquisition by a publicly traded corporation of all of the assets of a target corporation); *cf*. Gregg D. Polsky & Adam H. Rosenzweig, *The Up-C Revolution*, 71 TAX L. REV. 415, 465–66 (2018) (describing the use of an Up-C structure in an acquisition by a publicly traded corporation of certain assets of another corporation). While the Up-C structure may be desirable to certain large shareholders (and the acquiring corporation), there may be downsides in that shareholders will either receive cash or publicly traded stock of the acquirer and thus recognize gain (with regard to the publicly traded stock, under this Article's proposal) or end up with minority interests in a non-publicly traded LLC that is taxed as a partnership. The transaction could be made more desirable to the target shareholders by giving them LLC interests that are exchangeable into the publicly traded stock of the acquirer. *See id.* But under this Article's proposal, such exchangeable interests would be treated as designed to be readily tradable on an established securities market, thereby preventing nonrecognition. *See supra* note 309 (calling for the use of the rules under Reg. § 15A.453–1(e)).

332. *See* Johnson, *Publicly Traded Stock*, *supra* note 126, at 1368.

333. *See supra* note 54 and accompanying text. As discussed previously, in light of the difficult-to-value factor, the treatment of boot received in nonrecognition transactions should be reconsidered. *See supra* notes 314–318 and accompanying text. Where a shareholder receives only boot in a transaction that qualifies as an acquisitive reorganization under the revised definition (which is possible given that the revised definition does not contain a continuity of interest requirement), the shareholder should be able to recognize any realized loss. *Cf.* Johnson, *Publicly Traded Stock*, *supra* note 126, at 1368 (proposing that a target shareholder who only receives publicly traded stock and other boot in a transaction should be able to recognize any realized loss). This is because such a transaction is in substance a sale. *See id.* at 1368.

corporations in transactions that qualify as acquisitive reorganizations under the revised definition,[334] which as mentioned above would not contain continuity of interest and continuity of business requirements.[335]

It should be mentioned, however, that denying nonrecognition treatment to shareholders that receive stock in publicly traded corporations could create a disincentive for either operating a corporation as a publicly traded entity, or engaging in a reorganization with a publicly traded corporation.[336] Thus, this measure could generate Time One efficiency costs by advantaging investments in non-publicly traded corporations over publicly traded ones[337] as well as generate Time Two efficiency costs by advantaging reorganizations with non-publicly traded corporations over publicly traded ones.[338] While these efficiency costs may occur, the differences in the availability of nonrecognition would seem to pale in comparison to the significant tax differences that exist between publicly traded and non-publicly traded corporations, which include the likely eligibility of S corporation status for non-publicly traded corporations and the resulting differences in the levels of taxation and the applicable tax rates. Thus, in choosing to conduct a corporate enterprise as either privately held or publicly traded, the prospect of nonrecognition treatment for the former but not the latter would not seem to be that important when compared to the overall differences in how these entities are taxed. Moreover, the decision by the owners of a privately held corporation to enter into an acquisitive reorganization with either another privately held company or a publicly traded corporation would also likely be affected by the tax treatment of the resulting entity, which in the case of the former but not the latter, could be an S corporation. In addition, frictions[339] may exist that hinder either using or merging with a privately held company to take advantage of nonrecognition treatment. These

334. Similar to section 351 transactions, valuation may still be necessary in connection with a qualifying corporate reorganization where a shareholder receives more than one class of stock in the transaction—for example, common and preferred stock. *See supra* note 318. The regulations generally permit shareholders to use a tracing approach, which permits shareholders to identify, through the terms of the exchange, the particular stock shares that are received for particular stock shares surrendered. Reg. § 1.358–2(a)(2). Where the taxpayer does not use this identification procedure, it is necessary to allocate the basis of the stock surrendered by the shareholder (as adjusted under section 358) between the stock of different classes, based on their relative fair market values. *Id.* While this may create some valuation difficulties, several considerations may mitigate these concerns. *See infra* note 377 and accompanying text.

335. In this regard, Professor Schlunk contends that the current rules for acquisitive reorganizations are extraordinarily complex, inconsistent, and arguably unfair. Schlunk, *supra* note 120, at 23. Among the problems that he identifies is that a shareholder who receives non-publicly traded stock in exchange for non-publicly traded stock in a merger would be taxable if the continuity of interest requirements are not satisfied, even though the stock received is both illiquid and difficult to value. *Id.* at 31. Professor Schlunk also notes the unfairness of having one shareholder's tax treatment depend on that of other shareholders, which occurs as a result of current law's continuity of interest requirement. *Id.* at 35–36. As indicated above, the reforms suggested by this Article would avoid this result.

336. *See* Bank, *supra* note 126, at 42–43 (suggesting that limiting nonrecognition treatment for mergers to privately held corporations may be a flawed policy because it could lead to a shift of resources from publicly traded corporations to privately held corporations); Schlunk, *supra* note 120, at 76 (pointing out that taxing shareholders on the receipt of publicly company stock in acquisitive reorganizations would lead to discrimination against public company transactions in favor of private company transactions).

337. Tax scholars had made similar arguments in connection with proposals to apply accrual taxation to only easy-to-value assets, such as publicly traded stock, while applying the realization requirement to other assets. *See* Brown, *Complete Accrual*, *supra* note 89, at 1606; Glogower, *supra* note 95, at 131; Schenk, *Efficiency Approach*, *supra* note 88, at 527–30; Zelinsky, *supra* note 266, at 915. Differences in the availability of nonrecognition treatment seem, however, to be less significant than applying accrual taxation to some assets and the realization requirement to other assets; even with the denial of nonrecognition treatment for publicly traded stock, deferral of gain recognition via the realization rule would still be largely available.

338. *See* Brauner, *supra* note 164, at 15 n.49 (stating that applying different treatment to public and private corporations involved in reorganizations is a bad idea).

339. *See supra* note 144 and accompanying text.

include the benefits of liquidity, stability, and disclosure that only publicly traded stock offers.[340] Consequently, the possible efficiency costs of denying shareholder nonrecognition treatment for the receipt of publicly traded stock do not seem relatively significant enough to warrant nonrecognition treatment for such transactions.

It should also be mentioned that any approach that taxes some acquisitive reorganizations presents the possibility of different tax results depending on the form of the transaction that is used. For example, if publicly held corporation *X* were merged into a publicly held corporation *Y* in exchange for stock of corporation *Y*, the shareholders of *X* would recognize any realized gain on the target stock based on this Article's recommendations. In contrast, if publicly held corporation *Y* were merged into publicly held corporation *X* in exchange for the stock of corporation *X*, the shareholders of *Y* would be the persons recognizing any realized gain. As a consequence, there would be a tax incentive for using a particular transactional form to carry out an acquisitive reorganization, thereby producing Time Two efficiency costs.[341] One solution would be to impose a deemed realization event on the shareholders of acquiring corporations, but this would likely result in publicly traded acquiring corporations refraining from using stock in corporate acquisitions.[342] Another solution is to go in the opposite direction and provide nonrecognition to all acquisitive reorganizations, irrespective of the receipt of difficult-to-value or illiquid stock (as well as whether continuity of interest and business requirements are satisfied).[343] However, compared to taxing target shareholders on the receipt of publicly traded stock, this would produce greater Time One efficiency costs by making investments in corporate stock more tax favorable,[344] as well resulting in less tax revenue, which would need to be recouped from other, possibly less efficient sources.[345] Given the downsides of the other options, the approach recommended by this Article seems to be the best of these options.

c. Corporation Consequences

Under the standards identified by this Article, a target corporation in a qualifying acquisitive reorganization should receive nonrecognition treatment to the extent that it receives stock in a non-publicly traded corporation for non-publicly traded assets, given the valuation and liquidity difficulties that would arise if the transaction were to be taxable. Where the target corporation receives publicly traded stock and/or cash in the transaction, however, the standard prescribed by this Article does not necessarily dictate specific tax treatment. It may be consistent with this standard for target corporations to continue to receive nonrecognition treatment on the receipt of cash[346] as well as on the receipt of property that is designed to

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340. *See* Schenk, *Efficiency Approach*, *supra* note 88, at 512 (mentioning stability and disclosure). A publicly traded corporation also has greater access to capital than a privately traded corporation, as the former has access to capital on the public markets whereas the latter does not.

341. *Cf.* Schlunk, *supra* note 120, at 63 (concluding that rules for corporate reorganizations that result in different tax consequences based on the form of the transactions will cause parties to expend significant energy to determine the least tax costly form to use); Shaviro, *supra* note 90, at 35 (stating that the existence of alternative ways to achieve a certain change in position that is needed for nontax reasons can produce high tax elasticity).

342. *See* Schlunk, *supra* note 120, at 60–61. Professor Schlunk may believe that this line of thinking would ultimately result in marked-to-market taxation for the shareholders of corporations, which would tax shareholders on their stock gains even in the absence of stock acquisitions. This may occur so as not to dissuade corporations from using stock to make acquisitions. *Id.* It should be noted that while marked-to-market or accrual taxation has several virtues, applying it selectively to certain types of assets would have efficiency costs. *See* Brown, *Complete Accrual*, *supra* note 89, at 1606; Zelinsky, *supra* note 266, at 915. Professor Schlunk also seems to see a deemed realization mechanism as a stable solution to the problems of having varying tax treatment for different forms for accomplishing corporate reorganizations. Schlunk, *supra* note 120, at 75–76.

343. *See* Schlunk, *supra* note 120, at 79–80 (recommending this approach for this and other reasons).

344. *See supra* note 114 and accompanying text.

345. *See supra* Part II.B.2.c.iv.

346. *See supra* note 56 and accompanying text.

be readily tradable on an established securities market, provided that the cash or readily tradable property is distributed to shareholders in the liquidation of the target corporation.[347] While there should be no valuation difficulties where all of the consideration received by the target corporation is either publicly traded stock or cash, and the publicly traded stock is liquid, the target may have difficulty paying any tax on recognized gain if all of the consideration received is distributed to its shareholders. Also, this approach can ensure that the gain or loss that is not recognized by the target is preserved for a future corporate-level tax by providing the transferee corporation with a transferred basis in the transferred assets, which is the case under current law.[348]

On the other hand, it would be consistent with the standards developed by this Article to require that the target corporation recognize any realized gain to the extent it receives publicly traded stock or cash, regardless of whether it distributes such stock or cash to its shareholders; the publicly traded stock is liquid (as is the cash, obviously), and the target corporation can pay any tax on recognized gain by withholding a portion of the distribution to its shareholders. Moreover, with the recommendation to eliminate the continuity of interest and continuity of business enterprise requirements that exist under current law,[349] an acquiring corporation's acquisition of all or substantially all of a target corporation's assets could qualify as a reorganization even if all of the consideration received by the target and its shareholders is cash. While the target shareholders will recognize their realized gain in this situation,[350] the target would not have a recognition event if the current rule contained in section 361(b) is followed.[351] Because it is inappropriate to permit nonrecognition at the corporate level on what are in effect sales for cash, this may be an additional reason for requiring the target to recognize gain on the receipt of boot, although boot for this purpose could exclude publicly traded stock in the acquiring corporation.[352]

4. Corporate Divisions and Distributions of Stock in Other Corporations

An application of the standard developed by this Article to corporate divisions[353] and other distributions of stock in other corporations suggests that major changes are generally not in order, except that nonrecognition should apparently be denied where the distributed stock is publicly traded. An application of the standard produces two overall issues. First, should nonrecognition treatment be expanded to apply to corporate distributions of stock in other corporation without regard to satisfying the current section 355 requirements? Second, should nonrecognition treatment be limited to distributions of stock that is not publicly traded after the distribution?

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347. *Cf.* Johnson, *Publicly Traded Stock*, *supra* note 126, at 1368 (proposing that target corporations not recognize gain on the receipt of publicly traded stock where the stock is distributed to target shareholders).

348. *See supra* note 57. Professor Coven would go further and mandate corporate-level nonrecognition/transferred basis treatment for corporate asset acquisitions that involve the acquisition of a business, regardless of the type of consideration received by the target corporation or its shareholders. Coven, *supra* note 249, at 182–83, 185. The rationale for this proposal is to eliminate the effective election that taxpayers have to achieve either nonrecognition/transferred basis treatment or recognition/cost basis treatment under current law, and to create a taxation scheme that is most consistent with the broad structure of the corporate tax system—that changes in the ownership of a corporate business do not trigger a corporate-level tax on the gain inherent in the assets retained in the business. *See id*. at 172, 192, 197.

349. *See supra* notes 321–323 and accompanying text.

350. *See supra* note 54 and accompanying text.

351. *See supra* note 56 and accompanying text. This assumes that all of the cash is distributed to shareholders in the liquidation of the target corporation.

352. Requiring the target to recognize realized gain where it receives only cash also seems consistent with the strong form of *General Utilities* repeal, which does not permit nonrecognition treatment for assets that are transferred outside of the historic group of shareholders to other shareholders who acquired their stock by purchase. *See infra* notes 364–367 and accompanying text. Where the target receives only cash in the transaction, the target should also be able to recognize any realized loss. This is because such a transaction is in substance a sale.

353. As discussed previously, the nonrecognition rules for corporate divisions are contained in section 355 along with related provisions. *See supra* Part II.B.3.

Regarding the first issue, applying *only* the difficult-to-value and illiquid property factors, corporate distributions of stock in other corporations would receive nonrecognition treatment as long as the distributed stock is not readily tradable on an established securities market, without regard to satisfying the current section 355 requirements.[354] As under current law for corporate divisions that qualify under section 355, the income not recognized by the distributee shareholders on the transaction could be preserved in the hands of the these shareholders via the exchanged basis rules that currently apply to section 355 transactions.[355] The gain or loss inherent in the assets of the corporation whose stock is distributed would also be preserved in the hands of this corporation following the distribution, given that the basis of these assets would remain unchanged.

Questions arise, however, whether such a broad nonrecognition for distributions of corporate stock would satisfy the other relevant factors for designing nonrecognition rules. That is, would such a rule be violative of certain corporate tax policy concerns? And would such a rule be narrowly tailored to common transactional forms that are typically selected for significant non-tax reasons, or would there be a serious concern that corporations would structure transactions to take advantage of nonrecognition treatment? Regarding the first question, as discussed previously, section 355 contains a host of requirements for achieving nonrecognition treatment for the distributing corporation and the distributee shareholders,[356] some of which go to concerns other than trying to ensure that the stock held by the distributee shareholders following the transaction is similar to their stock holdings before the transaction. That is, while the continuity of interest requirement contained in these rules is apparently aimed (at least in part[357]) at maintaining the similarity of stock holdings of the distributee shareholders before and after the transaction, other rules—namely, the active business, corporate business purpose, and no device requirements—effectuate certain corporate tax policies. The active business requirement prevents a corporation from making a tax-free distribution that has the effect of separating liquid assets as a substitute for paying a taxable dividend in cash or liquid property.[358] Similarly, the no device requirement prevents the distributing corporation and its shareholders from using section 355 to avoid the dividend provisions through a tax-free distribution of stock in the controlled corporation followed by a sale of the distributed stock.[359]

In addition, a broad nonrecognition rule for distributions of corporate stock would seem to be in violation of *General Utilities* repeal,[360] because any unrealized gain on the distributed stock would be permanently excluded from the tax base. This gain will not be preserved in the hands of the distributee shareholder because the distributee's adjusted basis in the distributed and retained stock will be determined with reference to this person's basis in the stock of the distributing corporation (with certain adjustments),[361] as opposed to the distributing corporation's basis in the distributed stock. Where the section 355 requirements are satisfied, this result is arguably justified as a policy matter because the distributing corporation would control the corporation whose stock is distributed, and thus the stock and its inherent gain or loss apparently may be properly ignored,[362] which also occurs in a parent-subsidiary corporate liquidation under section 332.[363] Moreover, section 355 arguably supports a "strong form" of *General*

354. *See supra* Parts IV.B–C.
355. *See supra* note 71.
356. *See supra* Part II.B.3.a.
357. *See infra* notes 368–369 and accompanying text.
358. *See* BITTKER & EUSTICE, *supra* note 311, ¶ 11.05[1].
359. *See* Reg. § 1.355–2(d)(1).
360. *See supra* notes 237–242 and accompanying text.
361. *See supra* note 71.
362. Presumably because of distributing corporation's ownership percentage in the stock of the controlled corporation, the distributing corporation can be viewed as an indirect owner of the controlled corporation's assets.
363. *See infra* notes 380–382 and accompanying text.

Utilities repeal,[364] which would also be frustrated with a broad nonrecognition rule for distributions of corporate stock. To explain, with a rule that gave nonrecognition treatment to a corporation whenever it distributed another corporation's stock, the corporate tax on any unrealized gain on the assets held by the corporation whose stock is distributed will be deferred but not avoided; this is because the assets would remain in corporate solution with their adjusted bases unchanged. Nevertheless, such a broad nonrecognition rule may be characterized as only a "weak form" of *General Utilities* repeal.[365] On the other hand, a "strong form" of *General Utilities* repeal would not permit nonrecognition treatment for assets that are transferred outside of the historic group of shareholders to other shareholders who acquired their stock by purchase.[366] More generally, the strong form of *General Utilities* repeal would not permit nonrecognition of corporate-level gain on the distributed property in the absence of clear congressional grace.[367] A rule that provided a distributing corporation with nonrecognition treatment on any distribution of non-publicly traded stock in other corporations could violate this policy.

It would then seem that a broad nonrecognition rule for corporate stock distributions would be problematic in light of these corporate tax policies. In addition, a rule that provided nonrecognition treatment to all distributions of non-publicly traded stock may not be narrowly tailored to common transactional forms that are typically selected for significant non-tax reasons, because corporations and shareholders could use the rule to circumvent either the dividend tax or *General Utilities* repeal. Consequently, the standard developed by this Article does not seem to call for an elimination of most of the current section 355 requirements. Even the complete elimination of the section 355 continuity of interest requirement may be questioned, in that it promotes the strong form of *General Utilities* repeal by denying nonrecognition treatment for assets that are transferred outside of the historic group of shareholders.[368] Thus, retaining the continuity of interest requirement solely for purposes of nonrecognition treatment for the distributing corporation may be appropriate.[369]

As to the second overall issue mentioned above, the difficult-to-value and illiquid property factors do call for an exception to nonrecognition treatment for distributions of publicly traded stock.[370] Yet, is nonrecognition for pro-rata spin-offs of publicly traded companies appropriate because such a distribution so clearly lacks non-tax significance that it may be presumed that the efficiency benefits from allowing nonrecognition outweigh any efficiency costs? Or stated in terms of the similar property standard, does the stock held by distributee shareholders after the transaction—the stock in the spun-off corporation and the stock in the distributing corporation—possess a very high degree of similarity to the stock in the distributing corporation that is held before the spin-off? There is a degree of similarity, in that after the distribution the

364. *See* Brett Wells, *Reform of Section 355*, 68 AM. U. L. REV. 447, 464–89 (2018) (contending that the post-1986 amendments to section 355 evidence Congress's desire to implement a "strong form" of *General Utilities* repeal).

365. *See id.*; Eric M. Zolt, *The* General Utilities *Doctrine: Examining the Scope of the Repeal*, 65 TAXES 819, 822 (1987).

366. *See* Wells, *supra* note 364, at 464–89; Zolt, *supra* note 365, at 822.

367. *See* Wells, *supra* note 364, at 464–89; Zolt, *supra* note 365, at 822.

368. *See supra* note 366 and accompanying text.

369. This would be similar to provisions under current law that require the recognition of corporate-level gain in certain transactions that have the effect of distributing assets outside the historic group of shareholders. *See* I.R.C §§ 355(c), 355(d), 355(e), 361(c). These provisions have no effect on the consequences at the shareholder level.

While this Article's analysis does not call for changes to most of the section 355 requirements, some changes may be warranted in order to promote the corporate tax policies underlying the rules. For proposed reforms in this regard, see, for example, Peter C. Canellos, *The Section 355 Edifice: Spinoffs Past, Present, and Future*, 104 TAX NOTES 419 (July 26, 2004); Wells, *supra* note 364; and Luke, *supra* note 277 (responding to Professor Wells).

370. Even though section 355 requires that the distributing corporation distribute stock or securities of a controlled corporation, with control for this purpose generally constituting at least 80% of the stock of a corporation (I.R.C. §§ 355(a)(1)(A), 368(c)), the stock of the controlled corporation may be publicly traded after the distribution. *See* Cathy A. Birkeland et al., *Spin-offs Unraveled*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Oct. 31, 2019), https://corpgov.law.harvard.edu/2019/10/31/spin-offs-unraveled/ (describing a spin-off in which a public company separates one or more of its businesses into a new, publicly traded company).

shareholders continue to hold the same corporate assets indirectly via their stock holdings, except now in the stock of two corporations instead of one corporation. However, for a few reasons, the stocks of the two companies after the distribution appear to be significantly different than the stock of the one company held beforehand. First, a spin-off will allow the separate managers of the distributing and spun-off companies to concentrate on the core business of each company, without being constrained by the needs of the other company's business, which could enhance the performance and results of each company.[371] In addition, a spin-off provides the separate corporations with the flexibility to pursue capital allocation strategies that are based on each company's business priorities, which could allow each company to achieve better capital costs and access to capital markets.[372] Finally, a spin-off could alleviate the investor confusion that may result from the consolidated financial reporting of the businesses of the two corporations prior to the spin-off; giving investors a clearer understanding of the separate businesses could increase the market value of each company.[373] Because a spin-off has these important effects on the two companies, the transaction does not appear to clearly lack non-tax significance so as to presume that the efficiency benefits from allowing nonrecognition outweigh any efficiency costs.[374] Consequently, it seems that nonrecognition should be denied for distributions involving publicly traded stock based on the difficult-to-value and illiquid property factors.

It should be pointed out that permitting nonrecognition treatment for certain distributions of non-publicly traded stock could still result in valuation difficulties. First, assuming that the aforementioned section 355 requirements remain, distributions of corporate stock that do not satisfy these requirements would be currently taxable; thus, the value of the distributed stock must be determined, which may be problematic where the stock is not publicly traded. Second, even where nonrecognition treatment is afforded (because the retained section 355 requirements are satisfied and the distributed stock is not publicly traded), the stock in the distributing and controlled corporations would still need to be valued in order for shareholders to determine their bases in the stock of the corporations following the distribution.[375] In a qualifying corporate division where stock in the distributing corporation is retained by a shareholder, the shareholder's bases in the stock of the distributing and controlled corporations after the distribution is determined by allocating the shareholder's basis in the distributing corporation stock before the distribution (with certain adjustments) between the distributing corporation stock and the controlled corporation stock, based on their relative fair market values after the distribution.[376] This then raises the question of whether the standard for nonrecognition developed by this Article supports nonrecognition treatment for any corporate divisions. While permitting nonrecognition treatment for certain corporate divisions does not eliminate valuation difficulties, arguably these difficulties are lessened with nonrecognition treatment, because it is only necessary to determine the relative values of the stocks in the distributing and controlled corporations rather than their absolute values; the former may be easier in certain situations.[377] Perhaps

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371. *See* Francis J. Aquila, *Key Issues When Considering a Spin-off*, PRAC. L., June 2015, at 20, 21–22, https://www.sullcrom.com/files/upload/June15_InTheBoardroom.pdf; Birkeland et al., *supra* note 370.

372. *See* Aquila, *supra* note 371, at 22 ("After the spin-off, the former parent company and the spun-off subsidiary would be able to obtain capital and finance projects based on their own risk level and growth projections."); Birkeland et al., *supra* note 370.

373. Aquila, *supra* note 371, at 22.

374. In the case of a split-off involving publicly traded stock, where the distributee shareholders can exchange some or all of their stock in the distributing corporation for stock in the split-off corporation, the case for presuming net efficiency benefits is even weaker, given that unlike in a spinoff, the shareholders' indirect interest after the transaction (via their stock holdings) is not even in the same corporate assets as it was before the transaction.

375. *Cf.* Eric D. Chason, *A Tax on the Clones: The Strange Case of Bitcoin Cash*, 39 VA. TAX REV. 1, 33–34 (2019) (pointing out that using the corporate division approach to tax the creation of new cryptocurrencies produces difficult valuation problems because of the need to value the cryptocurrencies to determine the bases of cryptocurrencies).

376. *See supra* note 71.

377. Furthermore, the stakes are arguably lower in valuing property for purposes of allocating basis, which may mean that reasonable estimates of values may be more acceptable in this context. These lower stakes are

more importantly, nonrecognition treatment for certain corporate divisions involving non-publicly traded stock is still fully supported by the illiquid property factor under the nonrecognition standard. Permitting nonrecognition treatment for such transactions will spare shareholders the costs that they may otherwise incur to fund the tax liability by either liquidating investments, borrowing funds, or diverting cash receipts.

5. Parent-Subsidiary Corporate Liquidations and Other Liquidations Involving Corporate Shareholders

An application of the standard developed by this Article to parent-subsidiary liquidations and other corporate liquidations involving corporate shareholders does not seem to call for changes. On the one hand, the difficult-to value and illiquid property factors could support nonrecognition treatment for both the liquidating corporation and corporate shareholders on *any* liquidating distribution to corporate shareholders, regardless of the corporate shareholder's stock ownership percentage in the liquidating corporation, provided that the distributed property is other than cash or readily tradable property. With such nonrecognition treatment, the gain or loss inherent in the property distributed to a corporate shareholder can be preserved in the hands of the corporate shareholder by giving the shareholder a transferred basis[378] in the property received. Similarly, having a corporate shareholder inherit its share of the liquidating corporation's E&P would preserve this E&P in the hands of the corporate shareholder.

However, such a broad nonrecognition rule would seem to violate the general rule that a liquidation should be a taxable event to the shareholder in order to apply a shareholder-level tax on the difference between the liquidated stock's value and basis.[379] In this regard, there would be no way for the gain or loss inherent in the liquidating corporation's stock to be preserved in the hands of the corporate shareholder; this is because the stock would no longer exist and the corporate shareholder's basis in the distributed assets would be the same as that of the liquidating corporation, in order to preserve the gain or loss inherent in the distributed assets.[380] Based on current law, this corporate policy is apparently effectuated by relegating nonrecognition treatment to situations where a corporate shareholder owns at least 80% of the liquidating corporation.[381] Presumably because of this controlling ownership percentage, the parent corporation can be viewed as an indirect owner of the subsidiary corporation's assets, and thus elimination of the corporate veil between the two corporations should not have tax significance.[382] Moreover, permitting nonrecognition to the liquidating corporation on the distribution of its assets to any corporate shareholders arguably violates the strong form of *General Utilities* repeal,[383] in that Congress has limited such nonrecognition treatment to parent-subsidiary liquidations, presumably for the reasons just mentioned. Therefore, a broad rule

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due to the following considerations: the determination of relative values only affects the allocation of basis, and a shareholder's aggregate basis in the stocks of the corporations involved will be unaffected; the significance of the basis allocation may be minimized by the effect of the time value of money, given that sales of the stocks in the corporations involved may occur several years later; and the significance of the basis allocation will be eliminated entirely if the stocks are not disposed of in taxable transactions until after the initial shareholder has died and her beneficiaries or heirs have received a basis in the stocks equal to their fair market values on the date of the shareholder's death. *See* I.R.C. § 1014.

378. *See supra* note 73.

379. I.R.C. § 331.

380. *Cf.* BITTKER & EUSTICE, *supra* note 311, ¶ 10.10[1] (stating that with nonrecognition for parent-subsidiary liquidations under section 332, the parent's stock basis in the subsidiary just disappears with "the effect of obliterating forever the parent's gain or loss on its investment in the subsidiary").

381. *See supra* notes 73–74 and accompanying text.

382. *See* BITTKER & EUSTICE, *supra* note 311, ¶ 10.10[1] (referring to section 332's assumption that "the elimination of the corporate veil between parent and subsidiary should have no tax significance"); Luke, *supra* note 277, at 44 (referring to the tacit assumption that a parent and subsidiary corporation are not separate taxpayers in the same way that two unrelated persons are separate taxpayers).

383. *See supra* notes 364–367 and accompanying text.

permitting nonrecognition for liquidating distributions of non-readily tradable property to a corporate shareholder does not seem in order based on this Article's approach.

In addition, disallowing nonrecognition treatment for parent-subsidiary liquidations that involve distributions of cash and/or readily tradable property is very questionable in light of this Article's standard for designing nonrecognition rules. As discussed previously, some transactions so clearly lack non-tax significance that it may be presumed that the efficiency benefits from allowing nonrecognition outweigh any efficiency costs.[384] This seems to be the case where a parent corporation liquidates an 80% or more owned subsidiary corporation.[385] Thus, while this Article generally dispenses with the similar property factor in designing nonrecognition rules, it seems appropriate to permit nonrecognition for a parent-subsidiary liquidation regardless of the whether the distributed property is easily valued and liquid.[386]

6. *Partner Contributions*

Section 721, which provides nonrecognition treatment on the contribution of property to partnerships by partners in exchange for partnership interests,[387] generally satisfies this Article's standard for designing nonrecognition rules, except to the extent the provision does not deny nonrecognition where the property contributed, or partnership interest received, is readily tradable on an established market. Other than this, the rule meets the difficult-to-value and illiquid property factors, and the provision appears to be narrowly tailored to common transactional forms that are typically selected for significant non-tax reasons.[388] Accordingly, section 721 should be revised to disallow nonrecognition treatment to the contributing partners for contributions of publicly traded property, as well as for the receipt of publicly traded partnership interests. The latter situation is rare, given that most publicly traded partnerships are treated as corporations for purposes of the Code.[389]

It should be mentioned that even with section 721, valuations of property contributed to a partnership are still necessary for purposes of section 704(c). In very general terms, section 704(c) requires that the built-in gain or loss on contributed property be allocated to the contributing partner upon the sale of the property,[390] and thus valuations of contributed property are needed to determine the amount of built-in gain or loss.[391] In addition, under the rules for determining whether allocations of partnership income and deductions to partners have substantial economic effect,[392] capital accounts must be maintained for the partners,[393] and this requires a determination of the fair market of property contributed by the partners.[394]

384. *See supra* notes 248–253 and accompanying text.

385. *See* Shaviro, *supra* note 90, at 54 (concluding that the tax-free treatment of parent-subsidiary liquidations presents a relatively easy case).

386. In terms of the similar property factor, the parent goes from holding an indirect interest in the assets of the subsidiary (via its controlling stock interest) to holding a direct interest in these assets.

387. *See supra* Part II.C.1.

388. For the same reasons stated in connection with section 351 (*see supra* note 311), the current prohibition on nonrecognition treatment under section 721(b) for transfers to partnerships treated as investment companies should be retained. *See supra* note 75.

389. I.R.C. § 7704(a), (c).

390. I.R.C. § 704(c). Section 704(c) also affects the allocation of depreciation deductions with respect to the contributed property. *See id.*; Reg. § 1.704–3(b)(1), (2). For discussion of section 704(c), see SCHWIDETZKY & BROWN, *supra* note 58, at 138–147.

391. Reg. § 1.704–3(a)(3) (defining built-in gain as the excess of the contributed property's book value over the contributing partner's tax adjusted basis upon contribution; defining built-in loss as the excess of the contributing partner's tax adjusted basis upon contribution over the contributed property's book value; defining book value as the fair market value at the time of contribution, with subsequent adjustments for cost recovery).

392. I.R.C. § 704(b).

393. Reg. § 1.704–1(b)(2)(iv)(*a*).

394. Reg. § 1.704–1(b)(2)(iv)(*b*).

Despite the need to value contributed property for these purposes,[395] section 721 still avoids the potential liquidity difficulties that would otherwise occur if partners were taxed on contributions of non-publicly traded property to partnerships. Permitting nonrecognition treatment for contributions of non-publicly property for non-publicly traded partnership interests will spare partners the liquidity costs that they may otherwise incur to fund the tax liability.

7. Partnership Distributions

Section 731, which generally provides nonrecognition treatment on distributions of property to partners,[396] should be left unchanged. As previously discussed, this provision as currently formulated satisfies the standard prescribed by this Article for designing nonrecognition rules.[397]

VI. CONCLUSION

The policies that arguably support the nonrecognition rules include the familiar trio of tax policy concerns—efficiency, equity, and tax administration. None of these policies, however, provide a strong basis for most of the nonrecognition rules as currently formulated. This Article generally dispenses with the efficiency and equity bases for the nonrecognition rules, and as a result, the similar replacement property factor, which currently is prominent in most nonrecognition provisions, should generally be discarded.

Accordingly, this Article proposes a standard for designing nonrecognition rules that generally ignores the similarities or differences in the relinquished and replacement properties, unless the properties are either identical or possess a very high degree of similarity, and instead takes into account the following: presence of difficult-to-value property, presence of illiquid property, use of rules that are narrowly tailored to common transactional forms that are typically selected for significant non-tax reasons, and adherence to certain corporate tax policies. This Article then applies this standard as a basis for suggesting revisions to the current nonrecognition rules. Included among the recommended reforms are (1) eliminating nonrecognition for like kind exchanges; (2) eliminating the control requirement for shareholders to receive nonrecognition upon transfers to corporations, but generally taxing shareholders on the transfer or receipt of publicly traded property; and (3) permitting nonrecognition in corporate reorganizations irrespective of satisfying continuity of interest or continuity of business enterprise requirements, but taxing shareholders on the receipt of publicly traded stock. Overall, the recommended approach and reforms should serve to rationalize and simplify the nonrecognition rules contained in the Code.

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395. It should be noted that even with these needs to value property, nonrecognition under section 721 may reduce the stakes involved in valuing property and, thus, may avoid what could be costly disputes between the IRS and taxpayers on the values of difficult-to-value properties such as intangibles and other unique assets.

396 *See supra* Part II.C.2.

397. *See supra* notes 286–290 and accompanying text.