

5-15-1985

California Tax Practitioners Beware: Even the Ninth Circuit's I.R.C. Section 1031 Loophole Has Limits

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Recommended Citation

Laurel A. Tollman *California Tax Practitioners Beware: Even the Ninth Circuit's I.R.C. Section 1031 Loophole Has Limits*, 12 Pepp. L. Rev. Iss. 4 (1985)

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B. California Tax Practitioners Beware: Even the Ninth Circuit's I.R.C. Section 1031 Loophole Has Limits

Section 1031 of the Internal Revenue Code provides tax deferred status for like-kind exchanges of investment property. The Deficit Reduction Act of 1984 amends this section to curb the use of the controversial delayed exchange as a tool to suspend tax assessment for an inordinate period of time. California attorneys should beware the future structuring of like-kind exchanges; for the amendment revises the lenient procedures for like-kind qualification sanctioned by the permissive Ninth Circuit.

I. INTRODUCTION—THE PROBLEM

Trudy Taxpayer grew bored with her miniature golf establishment in Encino. She learned from reliable sources that the tempestuous weather threatening the Malibu coastline every winter had created a great demand for sand bags among the residents. Eager to delve into the new venture, Trudy contacted Bernie Broker, who promised to find someone willing to trade an oceanfront lot for her miniature golf course. Bernie located Edward Exchangee, III, whose life-long dream was to own a miniature golf course in Encino, but who, alas, owned no oceanfront property. Edward wanted to take immediate possession of the miniature golf operation and promised to find Trudy a suitable sand-filled lot.

Trudy comes to you, a California tax attorney, for advice regarding the tax consequences of the contemplated deal. You are thus confronted with the complexities of a like-kind exchange; a transaction whereby business and investment properties are traded, rather than sold, resulting in a deferral of taxable gain. Section 1031 of the Internal Revenue Code, which governs like-kind exchanges, has been amended by the Deficit Reduction Act of 1984.¹ The amendment alters the procedures for successful deferral of gain realized in an exchange. This article analyzes the amended section 1031, and examines the consequences of the amendment with a view to its impact on the California practitioner.

1. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 77, 1984 U.S. CODE CONG. & AD. NEWS (98 Stat.) 595-596 (to be codified at I.R.C. § 1031).

II. THE LEGISLATIVE HISTORY UNDERLYING SECTION 1031

The concept of tax deferral for exchanges of like-kind property first appeared in section 202 of the Internal Revenue Code of 1921.² Its stated purpose was to encourage investment by allowing deferral of tax “for those exchanges or ‘trades’ in which, although a technical ‘gain’ may be realized under the present law, the taxpayer actually realizes no cash profit.”³

After a flurry of amendments in 1923, 1924, and 1939, section 202 evolved into section 1031 of the 1954 Internal Revenue Code.⁴ Codification of like-kind exchanges represents an exception to the general rule that gain or loss on exchange of property shall be recognized.⁵ Section 1031, therefore, allows the taxpayer to defer any gain until actually realized in cash or other taxable disposition.⁶

To qualify for nonrecognition of gain or loss under section 1031, the taxpayer must demonstrate compliance with the following requirements: 1) the taxpayer must hold and receive property for productive use in trade or business or for investment;⁷ 2) the taxpayer’s property

2. Revenue Act of 1921, ch. 136, tit. II, § 202(c)(1), 42 Stat. 227, 230 (1921). Section 202(c) provided that gain or loss would not be recognized in a like-kind exchange unless property received by the taxpayer had “a readily realizable market value.” *Id.* Section 202 was modified in 1924 because of the difficulties inherent in applying the “readily realizable market value” test. *See Jordan Marsh Co. v. Commissioner*, 269 F.2d 453, 454-56 (2d Cir. 1959), for a comprehensive discussion of the legislative history behind section 1031.

3. S. REP. NO. 275, 67th Cong., 1st Sess. 11 (1921).

4. I.R.C. § 202(c)(1) (1921), *amended by* I.R.C. § 203 (1924), *amended by* I.R.C. §§ 112(b)(1), (c)(1), (e), 113(a)(6) (1939), *amended by* I.R.C. § 1031 (1954) (amended 1984).

5. I.R.C. § 1001 (1982). Section 1001(c) states: “Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.” *Id.* § 1001(c). Please note that section 1031 is not an elective provision. Therefore, if the transaction is deemed a like-kind exchange, loss as well as gain will not be recognized. I.R.C. § 1031(c) (West Supp. 1984).

6. I.R.C. § 1031(a) (West Supp. 1984). Deferred exchanges have frequently been labeled “tax-free exchanges.” In actuality, tax liability is not eliminated; it is merely deferred until subsequent disposition. Like-kind exchanges may result in a tax-free transaction should the property remain with the taxpayer until his death, at which time it would pass through his estate to his heirs or devisees. Since, by definition, the taxpayer’s basis on the date of his death is equal to the fair market value of the property, there is no taxable gain to the heirs or devisees. *See* I.R.C. § 1014(a) (1982).

7. I.R.C. § 1031(a) (West Supp. 1984). Courts have deemed a variety of properties as held for productive use in trade or business or for investment. *See, e.g., Starker v. United States*, 602 F.2d 1341 (9th Cir. 1979) (timberland traded for contract right to receive property in the future was considered like-kind because contract right was found to be the equivalent of a fee interest in land); *R.A. Farish*, 14 T.C.M. (P-H) ¶ 45,056 (1945) (machinery traded for construction equipment); *see also National Outdoor Adv. Bureau, Inc. v. Helvering*, 89 F.2d 878 (2d Cir. 1937) (cars and trucks used by company employees to locate advertising space exchanged for new cars and trucks). The phrase “for productive use in business” has been held to contemplate any use “es-

must be exchanged solely for property of a like-kind;⁸ 3) the taxpayer must display an intent to exchange, not to sell and reinvest;⁹ and 4) the taxpayer must assure that his property is not one of the intangible properties specifically excluded by the statute.¹⁰

The tax advantages offered by section 1031 compelled many taxpayers to seek like-kind exchanges. However, locating a person both interested in an exchange and owning property desirable to the taxpayer often proved to be an arduous task. As a result, taxpayers began to stretch section 1031 to its limits through the use of multi-party

sential to commerce or manufacture; that is, to the performance of services, as well as to the creation of material things." *Id.* at 880.

Properties are not held for use in trade or business or for investment if they are held primarily for resale or for personal use. *See, e.g., Regals Realty Co. v. Commissioner*, 127 F.2d 931 (2d Cir. 1942) (nonrecognition of gain denied when property received in exchange was offered for resale); *Black v. Commissioner*, 35 T.C. 90 (1960) (nonrecognition of gain denied when property offered in exchange was not held for productive use in business or for investment, but was held for sale).

Treas. Reg. § 1.1031(a)-1(b), T.D. 6935, 1967, 32 Fed. Reg. 15,822 (Nov. 17, 1967) states: "Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale." Further, Treas. Reg. § 1.1031(a)-1(a), T.D. 6936, 1967, 32 Fed. Reg. 15,822 (Nov. 17, 1967) (codified at 26 C.F.R. § 1.1031(a)-1 (1984)), in pertinent part provides: "[P]roperty held for productive use in trade or business may be exchanged for property held for investment. Similarly, property held for investment may be exchanged for property held for productive use in trade or business."

8. I.R.C. § 1031(a) (West Supp. 1984).

[T]he words "like-kind" have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class.

Treas. Reg. § 1.1031(a)-1(b), T.D. 6935, 1967, 32 Fed. Reg. 15,822 (Nov. 17, 1967) (codified at 26 C.F.R. § 1.1031(a)-1 (1984)). The regulation illustrates this concept with examples such as an exchange of a used truck for a new truck, or city real estate for a ranch or farm. *Id.*

9. *Biggs v. Commissioner*, 632 F.2d 1171 (5th Cir. 1980) (nonrecognition of gain allowed on exchange involving four parties because each leg of the transaction was part of a single, integrated plan); *Alderson v. Commissioner*, 317 F.2d 790 (9th Cir. 1963) (nonrecognition allowed on exchange of property for an obligation to acquire property since escrow agreement demonstrated intent to exchange). These cases represent the proposition that intent not only refers to the subjective desires of the taxpayer, but may be inferred from the overall result of the transaction.

10. I.R.C. § 1031(a) (West Supp. 1984). Intangible properties excluded under section 1031(a)(2) are: "(A) stock in trade or other property held primarily for sale, (B) stocks, bonds or notes, (C) other securities or evidences of indebtedness or interest, (D) interests in a partnership, (E) certificates of trust or beneficial interests, or (F) choses in action."

For a detailed explanation of section 1031's statutory requirements, see generally R. GOODMAN, REAL PROPERTY EXCHANGES 19-57 (1982).

and delayed exchanges.¹¹

III. THE *STARKER* CASE AND THE DELAYED EXCHANGE

A delayed or nonsimultaneous exchange occurs where the transfer of the "target property" for the taxpayer's property does not take place at the same time. This concept reached its extreme in *Starker v. United States*,¹² where the Ninth Circuit held that a five year delay in the transfer of the target property qualified for like-kind treatment.¹³

In the *Starker* case, as illustrated by the Trudy Taxpayer hypothetical, Starker transferred legal title and possession to Crown Zellerbach Corporation in exchange for a contract right to receive property to be designated by Starker in the future.¹⁴ The Ninth Circuit determined that the *Starker* scenario qualified as a permissible like-kind exchange on the ground that the policy of section 1031 is to prevent inequity by: 1) deferring consideration of tax liability until the value of the exchange property is made certain by its subsequent sale and, 2) deferring collection of tax revenue until the taxpayer has "cashed in" on his investment in trade or business property.¹⁵

Congress flatly rejected the interpretation that the policy underlying section 1031 necessitated deferral of the valuation problem, stating: "[T]he transferred property must be valued at a specific or near-specific dollar amount in order to determine the aggregate value of the properties that the taxpayer may receive in the future. Thus, the taxpayer's gain may be measured with reasonable accuracy in the year of the original transfer."¹⁶

Congress also rejected the presumption that section 1031 permitted deferral of taxation because the taxpayer had not yet "cashed in" on his investment.¹⁷ The underlying policy of section 1031 is to defer imposition of tax on the gain from the original investment only when

11. Goldstein & Lewis, *Tax Treatment of Like-Kind Exchanges of Property Used in a Trade or Business or for Investment*, 5 REV. TAX'N OF INDIVIDUALS, 195, 252 (1981).

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

13. *Id.* at 1355.

14. *Id.* at 1342-43.

15. *Id.* at 1352. The *Starker* court noted:

The legislative history reveals that the provision was designed to avoid the imposition of a tax on those who do not "cash in" on their investments in trade or business property. Congress appeared to be concerned that taxpayers would not have the cash to pay a tax on the capital gain if the exchange triggered recognition.

Id. Although an apparent consideration of the drafters of the section was the difficulty of valuing property exchanged for the purpose of measuring gain or loss, it was not seen by the court as the controlling consideration in the enactment of section 1031. *Id.*

16. H.R. REP. NO. 432 (Part II), 98th Cong., 2d Sess. 1232-33 (1984).

17. *Id.* at 1233.

it remains "tied up in a continuing investment of the same sort."¹⁸ Although the *Starker* court made due mention of the "continuing investment rationale," the effect of its final holding was contrary to this principle.¹⁹ A long-term delay, such as that sanctioned by *Starker*, fails to accommodate the annual accounting requirement of the code by allowing the tax consequences of the transaction to remain uncertain.²⁰

IV. THE AMENDMENT OF SECTION 1031

The Ninth Circuit's permissiveness toward delayed exchanges prompted Congress to amend section 1031 to permit only those parties continuing their investment in similar property to delay for a statutorily prescribed period of time.²¹ Although section 1031 does not specifically require simultaneous transfer of the exchanged properties, substantial delay in identifying and exchanging the target property causes procedural and administrative uncertainty. During an "open-ended exchange," circumstances may require the taxpayer to shift his investment to non-like-kind property or to accept a partial exchange with the remaining balance paid in cash, making appropriate tax treatment problematic. Further, the Internal Revenue Service may encounter difficulty collecting the tax on the delayed partial exchange if the statute of limitations has expired.²²

Concerned by the prospect of the taxpayer receiving non-like-kind property during the lag time between transfers,²³ Congress amended section 1031 to limit the *Starker* loophole.²⁴ The amendment requires that the target property be identified within forty-five days of receipt of the taxpayer's property and received within the earlier of the following two time periods: 180 days of the initial transfer, or by the due

18. *Jordan Marsh Co.*, 269 F.2d at 456.

19. *Starker*, 602 F.2d at 1352.

20. I.R.C. § 6072 (1982). This section indicates that tax must be reported on an annual basis. See Feder, *Starker: The Deferred Tax-Free Exchange Resurrected*, 7 J. OF REAL ESTATE TAX'N 218, 228-31 (1979-80) for elaboration on the administrative difficulties caused by the delayed exchange upheld in the *Starker* case.

21. H.R. REP. NO. 432 (Part II), 98th Cong., 2d Sess. 1232 (1984). See *infra* note 87 and accompanying text for a description of the time period imposed by amended section 1031.

22. I.R.C. §§ 6501-6504 (1982). These sections cover the various statutes of limitations relating to tax collection. The applicable statute of limitations will depend to a large degree on the facts of each particular case.

23. H.R. REP. NO. 432 (Part II), 98th Cong., 2d Sess. 1232 (1984).

24. I.R.C. § 1031 (West Supp. 1984) (amending I.R.C. § 1031(a) (1982)).

date of the transferor's return.²⁵ The new section 1031(a), therefore, eliminates the "open-ended" exchange adopted in *Starker*.

V. COMPLIANCE WITH THE NEW SECTION 1031: ADVICE TO THE PRACTITIONER

The far-reaching effects of the amended section 1031 pose potential problems and strategy changes for the real estate broker, the land speculator, the title insurance company, the accountant and, of course, the practicing tax attorney. Two new requirements demand immediate attention by the practitioner: 1) the identification requirement, and 2) the exchange completion requirement.

A. *Dealing with the Identification Requirement*

Congress has set forth few guidelines regarding the identification requirement. As a result, three aspects of the amendment open to interpretation are: 1) the actual length of the identification period; 2) steps necessary to attain "identified property" status; and 3) multi-property designations.

1. Length of the Identification Requirement

Compliance with the identification requirement of the newly-amended section requires that the taxpayer designate the target property "before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange."²⁶ In actuality, this allows the taxpayer only forty-four days after the initial transfer to identify the target property. The conference report relating to the amendment indicates that a forty-five day time period was intended.²⁷ However, until a technical correction is made to section 1031(a)(3)(A), the practitioner should make sure that his taxpay-

25. I.R.C. § 1031(a)(3) (West Supp. 1984). This subsection provides:

(3) Requirement that property be identified and that exchange be completed not more than 180 days after transfer of exchanged property. —For purposes of this subsection, any property received by the taxpayer shall be treated as property which is not like-kind property if —

(A) such property is not identified as property to be received in the exchange before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange, or

(B) such property is received after the earlier of —

(i) the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or

(ii) the due date (determined with regard to extension) for the transferor's return of the tax imposed by this chapter for the taxable year in which the transfer of the relinquished property occurs.

Id.

26. I.R.C. § 1031(a)(3)(A) (West Supp. 1984).

27. H.R. REP. NO. 861, 98th Cong., 2d Sess. 866 (1984), where the Conference Report states that "transferors are permitted 45 days after the transfer to designate the property to be received"

ing client identifies the target property by the forty-fourth, and not the forty-fifth, day after the original transfer.²⁸

2. "Identified Property" Status

The language of the amendment fails to delineate the necessary procedure for identifying property. The House Conference Report suggests that this requirement may be satisfied by designating the target property in a written contract between the parties.²⁹ Prior to inclusion of the identification requirement, case law indicated that an oral understanding would qualify an exchange for section 1031 treatment if the parties intended to effectuate an exchange, and such exchange actually occurred.³⁰ The Conference Report did not specify designation in a written contract as the sole method of compliance.³¹ Apparently, Congress' intention was to provide evidentiary assurance of a continuing investment in like-kind property, most likely barring the efficacy of oral agreements. As a practical matter, therefore, attorneys should counsel their clients to remain within the safe harbor offered by contractual designation until regulations or further case law settle this issue.

3. Multi-Property Designation

The third aspect of the amendment open to interpretation involves multi-property designation. This allows the taxpayer to identify more than one parcel of property, subject to final selection between these alternatives, at a date subsequent to expiration of the forty-five day period. According to the House Conference Report, the properties initially selected must be limited in number, and the property ultimately designated must be identified as a result of "contingencies beyond the control of both parties."³² The report suggests that basing the selection upon approval of zoning changes would constitute a "contingency beyond the control of both parties."³³ However, it re-

28. Levine & McCormick, 61-4th *Tax Free Exchanges Under § 1031*, Tax Mgmt. Portfolio, Nov. 12, 1984, at 54.

29. H.R. REP. NO. 861, 98th Cong., 2d Sess. 866 (1984).

30. See *Starker*, 602 F.2d at 1355; *Franklin B. Biggs v. Commissioner*, 632 F.2d 1171, 1177 (5th Cir. 1980); *Arthur E. and Glenda Brauer v. Commissioner*, 74 T.C. 1134 (1980). The *Brauer* court noted: "We believe it is immaterial that the parties only orally agreed to effect an exchange since, 'tax consequences must depend on what was actually intended.'" *Id.* at 1141.

31. H.R. REP. NO. 861, 98th Cong., 2d Sess. 866 (1984).

32. *Id.*

33. *Id.* The Conference Report provides this illustration: "For example, if A

mains to be seen what other contingencies would qualify. The practicing attorney would be well advised to be wary of contingencies contractually determined in advance by the parties.³⁴ In light of the zoning approval example given in the House Conference Report as indicated above, it appears that Congress intended the contingencies to be determined by impartial, uninvolved third parties, such as state or federal administrative agencies.

The identification requirement may prove to be an unwanted addition to section 1031. It has the potential of reducing the efficiency of legitimate multi-party exchanges by forcing exchange participants unable to locate suitable exchange property to postpone the exchange, thereby risking the loss of a potential buyer requiring immediate possession of the relinquished property.

B. The Exchange Completion Requirement

Section 1031(a)(3)(B) provides that the taxpayer must receive the target property by the earlier of 180 days after the initial transfer or the due date of the transferor's tax return to qualify for like-kind

transferred real estate in exchange for a promise by *B* to transfer property *1* to *A* if zoning changes are approved and property *2* if they are not, the exchange would qualify for like-kind treatment." *Id.*

34. The Conference Report fails to supply any indicia to determine which events qualify as "contingencies beyond the control of both parties." Great potential for abuse arises when parties are free to contemplate events which artificially create contingencies beyond their control. Consider the situation in which the parties contract that if the Dodgers win the World Series, they will select Property *A* and if not, they will select Property *B*.

Although Congress remained silent as to the reason for requiring contingencies to be beyond the control of both parties, the probable intent was to prevent illegitimate use of multi-property designation to circumvent the identification deadline. Multi-property designation operates as an escape hatch for parties not able to forecast in advance the outcome of events, such as zoning, which materially affect the contract. Apparently, the provision was adopted to inject flexibility into the arbitrarily imposed identification requirement.

Congress may also have intended that the contingency bear a reasonable relation either to the agreement between the parties or to the exchanged properties. However, a reasonable relation test is not, by itself, sufficiently broad to thwart abuse. Consider a contract which bases selection between the alternative properties on fluctuations in the properties' market value. Although this event meets both the "reasonable relation" and "beyond the control" tests, it is no less arbitrary than basing the selection on the winner of the World Series.

See *Levine & McCormick, supra* note 91, at 55. Here, the commentators indicate that use of property value fluctuations as a contingency may not qualify under the amended statute since the manner of designation reduces the taxpayer's investment risk and, thus, contradicts the continuity of investment rationale underlying section 1031. *Id.* The potential to abuse proper selection of a contingency suggests that the commentators' concern is well-founded, regardless of whether the Internal Revenue Service speculates as to the degree of taxpayer risk incurred or confines itself to the collection of taxable revenue. Until Congress provides guidelines to clarify the meaning of "contingencies beyond the control of both parties," the practitioner may be well advised to seek a private letter ruling from the Internal Revenue Service.

treatment.³⁵ This "exchange completion" requirement lays to rest many issues debated in case law and, at the same time, limits the variety of tax planning devices previously available under section 1031. Tax planners should beware structuring an exchange in connection with: 1) constructive receipt of cash, 2) construction agreements, and 3) installment payments.

1. Avoid Constructive Receipt of Cash

The amendment's 180-day time limit on completion of the exchange forces the taxpayer to elect early on whether to accept property or cash in return for his property. Any receipt of cash during the exchange period will disqualify an otherwise valid exchange. Disqualification results because, as a matter of definition, actual or constructive receipt of money by the taxpayer transforms the exchange into a taxable sale.³⁶ Constructive receipt of cash occurs, for example, when the taxpayer has the ability to access cash placed in an account by the transferor to secure the exchange transaction. To avoid a finding of constructive receipt, the attorney should carefully draft instructions curtailing the taxpayer's ability to access such an account.

When drafting an exchange agreement, the attorney should specify in writing that it is the parties' intention to effectuate an exchange, not a sale, and that any right to pay cash in lieu of an exchange re-

35. I.R.C. § 1031(a)(3)(B) (West Supp. 1984). The text of the amendment states that once the taxpayer has relinquished his property, the target property must be received by the earlier of 180 days or the due date of the transferor's return (*including extensions*). In most instances, 180 days will be the statutory maximum since parties wishing to exchange near the close of their taxable year can obtain a six-month extension of time to file their tax return. I.R.C. § 6081 (1982) offers taxpayers an automatic four-month extension of time to file their tax return. To obtain the extension, the taxpayer need only estimate the tax owed for the year on Form 4868 and include payment of the estimated tax when the form is filed. Form 2688 provides an additional two-month extension which will be granted upon a showing of good reason and prior use of the automatic four-month extension. If additional extensions are required, the attorney may wish to peruse section 6081 to see if his client qualifies for any of the special extension rules available for certain taxpayers.

36. *Starker*, 602 F.2d at 1354. Cf. *Carlton v. United States*, 385 F.2d 238 (5th Cir. 1967). The *Starker* case, deciding an issue unaffected by the amendment and representing current law, held that the right to receive cash was permissible under section 1031 because the transferor, not the taxpayer, could elect to pay cash if suitable exchange property could not be located. In *Carlton*, the taxpayer retained the right to demand cash at any time and was disqualified from like-kind treatment because the cash in lieu provision was considered constructive receipt of cash.

For a more complete explanation of the constructive receipt doctrine and an analysis of applicable case law, see Goldstein & Lewis, *supra* note 74, at 258-66. For a discussion on the avoidance of constructive receipt of cash when using an escrow or trust, see *id.* at 278-82.

mains within the sole discretion of the transferor.³⁷ Further, any escrow or trust used to secure the transaction should contain substantial restrictions on the taxpayer's right to receive cash. Such restrictions include no right to demand specific performance, no right to interest accruing in the account, and no right to payment from the fund in the event of default.³⁸ In essence, the taxpayer's only right of access to the funds should be as a creditor with the qualification that the funds in default must be used to purchase like-kind property. Otherwise, the exchange will be labeled a sale and lose its tax-deferred status.

2. Construction Agreements

The attorney should also proceed with caution when drafting a construction agreement in connection with an exchange. Under such agreements, the transferor acquires land and constructs a building or other improvement desired by the taxpayer.³⁹ In California, the transferor bears the risk of loss until the taxpayer takes possession or has legal title.⁴⁰ Since the amendment requires transfer of title to the taxpayer within 180 days of the initial exchange, the attorney may wish to contractually allocate the risk of loss to the transferor in the event construction cannot be completed in the time allotted.

3. Use of Installment Payments in a Like-Kind Exchange

The exchange completion requirement forecloses the taxpayer's option to receive cash and elect installment sale treatment when an exchange proves unsuccessful several years after the initial transfer.⁴¹ Under the installment rules embodied in section 453 of the Internal Revenue Code, the taxpayer pays tax solely on installments received per taxable year.⁴² Often, these rules will produce a more favorable tax result than the exchange rules. However, if exchange treatment is contemplated, the attorney should closely examine the tax consequences of each rule and unequivocally indicate which rule

37. See *supra* note 99 and accompanying text.

38. Rev. Rul. 79-91, 1979-1 C.B. 179. This ruling states that the escrowed funds should remain unavailable to the taxpayer at all times and under all circumstances. However, escrow instructions stating that, in the event of default, the funds may be used to purchase property selected by the taxpayer would probably not disqualify the exchange from like-kind treatment.

39. Rev. Rul. 75-291, 1975-2 C.B. 332. The ruling indicates that the exchange will remain tax-deferred as long as the purchaser constructs the improvement on his own behalf and not as the taxpayer's agent. The purchaser, on the other hand, can never receive tax-deferred treatment under this fact pattern since the property he acquired was not held for use in trade or business or for investment. *Bloomington Coca-Cola Bottling Co.*, 19 T.C.M. (P-H) ¶ 50,189 (1950), *aff'd*, 189 F.2d 14 (7th Cir. 1951).

40. CAL. CIV. CODE § 1662 (West 1973).

41. Levine & McCormick, *supra* note 91, at 56.

42. Installment Sales Revision Act of 1980 § 2, I.R.C. § 453 (1982).

has been chosen. Any uncertainty shrouding the taxpayer's intent may cause the exchange to lose its tax-deferred status because of the taxpayer's potential to receive cash.⁴³

The exchange completion requirement has not fully foreclosed the possibility of using sections 1031 and 453 in tandem.⁴⁴ The exchange and installment rules may still be profitably combined in a "partially tax-deferred exchange." A "partially tax-deferred exchange" occurs when the properties exchanged are of unequal value and "boot" is received to equalize the difference. "Boot" may consist of cash, mortgages, notes or other property, and serves to compensate for the discrepancy in price. Generally, "boot" is taxed as ordinary income. However, section 453 permits the taxpayer to defer most of the tax attributable to "boot" by electing to pay the "boot" in installments.⁴⁵ To use section 1031 and 453 in tandem, the attorney should bifurcate the transaction so that the exchange rules apply to defer tax on the property received, and the installment rules apply to defer tax on any "boot" received.

VI. EFFECTIVE DATES OF THE AMENDMENT

The Deficit Reduction Act provides that the identification and exchange requirements of section 1031 in its amended form apply to transfers after the date of enactment, July 18, 1984.⁴⁶ Transfers occurring on or before July 18, 1984 must be completed before December 1, 1986 to receive like-kind treatment, unless the parties designated the exchange property in a binding contract entered into before June 14, 1984 and the property so designated is received on or before December 31, 1988. Any tax deficiency occurring as a result of the exchange's failure to qualify as like-kind may be assessed until January 1, 1988.

VII. SUMMARY

The codification of like-kind exchanges in section 1031 of the Inter-

43. See *supra* notes 98-100 and accompanying text for a discussion of the consequences ensuing from receipt of cash during an exchange.

44. "[T]he term payment . . . shall not include any property permitted to be received in . . . [a like-kind] exchange without recognition of gain," thereby sanctioning the use of sections 453 and 1031 in combination to allow the taxpayer to pay tax on any "boot" received in installments. I.R.C. § 453(f)(6)(C) (1982).

45. I.R.C. § 453B(a)(1) (1982).

46. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 77(a)(3); 1984 U.S. CODE CONG. & AD. NEWS (98 Stat.) 494, 595-596 (to be codified at I.R.C. § 1031).

nal Revenue Code presents an exception to the general rule that gain or loss on an exchange of property shall be recognized. This rule was soon stretched to its limits by sophisticated taxpayers who forestalled taxation by delaying their exchange for an indefinite period of time. The controversy surrounding delayed exchanges prompted Congress to tighten the *Starker* loophole by adding a time element to section 1031.

The amendment itself, however, begets as many problems for the practitioner as it solves. The time period imposed by the amendment increases the likelihood of constructively receiving cash. Its brevity also makes precarious the use of like-kind exchanges in tandem with construction agreements and installment payments. As a result, the practitioner must closely scrutinize the form of the like-kind exchange to ensure that it punctiliously meets both the identification and exchange completion requirements.

Armed with this knowledge of the amended section 1031, you are now equipped to handle the intricacies of Trudy's contemplated exchange. With due care in structuring the exchange, Trudy can meet the deadline for identification and exchange, and commence operating her business to save the Malibu coastline.

VIII. CONCLUSION

Section 1031 as amended promises to have far-reaching implications with regard to like-kind exchanges of property in California. Taxpayers and their attorneys should be aware that loopholes existing under the Ninth Circuit's *Starker* decision have been tightened by time limitations enacted under the amendment. Many ambiguities persist in the amended section, therefore, prudence is advised until regulations are promulgated to clarify Congress' intention.

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* I would like to acknowledge Michael Gradisher whose creative input helped to shape the format and literary style of this Cal Practicum.