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THE LIKE-KIND EXCHANGE EQUITY CONUNDRUM

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Abstract

The tax-free treatment of like-kind exchanges presents one of tax law's most compelling equity conundrums. Tax law generally does not tax property holders on the property's appreciation but does tax gain or loss recognized by property sellers and exchangers of non-like-kind property. In the basic Aristotelian system, equity requires that likes be treated alike, but the system does not provide criteria to determine what is alike. Depending upon the criteria, exchangers of like-kind property can be similar either to holders or to sellers and exchangers of non-like-kind property. The equity conundrum asks whether tax law should treat exchangers of like-kind property either the same as holders of property or the same as sellers and exchangers of non-like-kind property. This Article frames the conundrum in Rawlsian and Hohfeldian concepts. This framing suggests first that holders should not be taxed on property's appreciation. Second, this framing explains that once tax law exempts holders' appreciation from taxation, equity requires that exchanges of like-kind property should also be exempt from taxation. Thus, equity suggests that the tax law should treat exchangers of like-kind property and property holders similarly.

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I. INTRODUCTION

Section 1031 of the Internal Revenue Code (Code) generally allows a property holder to ignore the property's appreciation when exchanging the property for like-kind property.[1] This provision of the Code is approaching its ninetieth anniversary[2] and has recently received significant public

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1. I.R.C. § 1031 (West 2008).

2. Congress enacted the predecessor to section 1031 in 1921. *See* Revenue Act of 1921, ch. 136, § 202(c), 42 Stat. 227, 230 (current version at I.R.C. § 1031) ("For the purposes of this title, on an exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value; but even if the property received in exchange has a readily realizable market value, no gain or loss shall be recognized (1) [w]hen any such property held for investment, or for productive use in a trade or business (not including stock-in-trade or other property held primarily for sale), is exchanged for property of a like kind or use . . . ."). For a review of the history of section 1031, see Bradley T. Borden, *Reverse Like-Kind Exchanges: A Principled Approach*, 20 VA. TAX REV. 659, 664–87 (2001) (discussing the purpose of section 1031 in the context of the section 1031 exchange requirement). *See also* Marjorie E. Kornhauser, *Section 1031: We Don't Need Another Hero*, 60 S. CAL. L. REV. 397, 400–41 (1987) (discussing the origins of section 1031, traditional explanations of its purpose, and possible factors influencing its enactment).

attention.[3] The recent attention results from the reported demise of two section 1031 qualified intermediaries.[4] Qualified intermediaries facilitate section 1031 tax-free exchanges. As part of the facilitation function, qualified intermediaries receive and hold the proceeds from the sale of exchange property.[5] The reported size of the exchange-balances of the two failed qualified intermediaries indicates the popularity of section 1031 exchanges—one qualified intermediary reportedly held as much as $95 million of exchange proceeds[6] and the other as much as $151 million of exchange proceeds.[7]

The failure of qualified intermediaries is unfortunate because many exchangers will likely lose the exchange proceeds that the qualified intermediaries held.[8] The qualified-intermediary failures will likely compel regulation of qualified intermediaries, including account maintenance rules, and more due diligence by exchangers choosing a qualified intermediary. Thus, reports of the qualified-intermediary failures will help strengthen the qualified-intermediary industry but probably will not affect section 1031's popularity among property owners.[9] Section 1031 has

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3. *See, e.g.*, Peter C. Beller, *Other People's Money*, FORBES, Apr. 23, 2007, at 38 (reporting Donald K. McGhan's acquisition of a qualified intermediary and his misuse of $95 million of exchange deposits); Peter Lattman & Kemba Dunham, *Tax Strategy for Real Estate Hits Rocky Turf: "QI" Ploy Draws Focus as Middlemen Develop Financial Difficulties*, WALL ST. J., May 26–27, 2007, at B1 (reporting the failure of two section 1031 qualified intermediaries); *Most Popular Articles on WSJ.com on May 28*, WALL ST. J., May 29, 2007, at B2 (reporting that Lattman and Dunham's May 26–27 section 1031 article about section 1031 was the most e-mailed and second-most viewed article for the reported period); Rachel Emma Silverman, *Risky "1031s" Have Safeguards*, WALL ST. J., May 31, 2007, at D6 (identifying tactics that exchangers may employ to protect exchange proceeds).

4. *See* Beller, *supra* note 3, at 38–39; Lattman & Dunham, *supra* note 3. The Treasury created the section 1031 qualified intermediary to make like-kind exchanges more convenient and accessible. *See* Treas. Reg. § 1.1031(k)-1(g)(4) (as amended in 2002) (describing qualified intermediaries). Prior to the promulgation of the qualified-intermediary regulations, the common-law principles of constructive receipt and agency governed like-kind exchanges. *See* Borden, *supra* note 2, at 669–73 (discussing the exchange requirement's property-for-property element, which prohibits the exchanger's actual or constructive receipt of proceeds from the sale of relinquished property). The qualified-intermediary regulations create a safe harbor that allows exchangers to exchange property with confidence that they will not be in constructive receipt of exchange proceeds and that the qualified intermediary will not be the exchanger's agent. *See* Treas. Reg. § 1.1031(k)-1(g)(1), -1(g)(4)(i) (as amended in 2002).

5. *See infra* text accompanying notes 49–57 (listing typical exchange structures); *see also* BRADLEY T. BORDEN, TAX-FREE SWAPS: USING SECTION 1031 LIKE-KIND EXCHANGES TO PRESERVE INVESTMENT NET WORTH 71–191 (2007) (describing the various exchange structures).

6. *See* Beller, *supra* note 3, at 39.

7. *See* Lattman & Dunham, *supra* note 3.

8. *See* Beller, *supra* note 3, at 39.

9. *But see* Kemba J. Dunham, *Tax Benefit Falls from Favor: Fraud Claims, High Prices for Commercial Properties Curb Use of "1031" Strategy*, WALL ST. J., June 13, 2007, at B13 (discussing a recent downturn in the number of section 1031 exchanges and attributing the

become a significant part of the U.S. economy, and the failure of the qualified intermediaries makes up only a small part of section 1031's story.[10]

Before the demise of the two qualified intermediaries, section 1031 often received positive public attention,[11] and property owners frequently exchanged like-kind property. Recently, a qualified intermediary, Investment Property Exchange Services, Inc. (IPX1031),[12] sent to the Internal Revenue Service a letter (the IPX1031 Letter)[13] that provides some insight into section 1031's popularity and scope. According to the IPX1031 Letter, IPX1031 facilitated 31,000 like-kind exchanges over a recent eighteen-month period.[14] IPX1031 is one of several hundred professional qualified intermediaries.[15] One can appreciate the popularity of section 1031 by extrapolating the number of exchanges that IPX1031 facilitates to include the exchanges facilitated by the hundreds of other qualified intermediaries.[16] Based on that extrapolation, annual section 1031 exchanges could number into the hundreds of thousands.

The IPX1031 Letter also suggests that a significant cross section of property owners exchange property under section 1031. IPX1031's analysis of 74,000 exchanges revealed that the vast majority (70%) of

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downturn, in part, to the slowdown in the real estate market and perhaps to the recent qualified-intermediary failures).

10. *See* Lattman & Dunham, *supra* note 3 ("The actions 'of a few persons should not taint either the broad 1031 market, which allows taxpayers to save significant taxes legally, or the honest [qualified intermediaries] who provide a useful service at low cost.'" (quoting Richard Lipton, tax attorney at Baker & McKenzie LLP)).

11. *See, e.g.*, Rachel Emma Silverman, *Bartering to Avoid Taxes: Popular Real-Estate Strategy Is Increasingly Used to Defer Capital Gains on Other Assets*, WALL ST. J., Dec. 29, 2005, at D1 (describing a baseball memorabilia exchange structured as a section 1031 exchange).

12. IPX1031 is a subsidiary of Fidelity Nation Information Services, Inc. (NYSE: FIS). *See* IPX1031—About IPX1031, http://www.ipx1031.com/about.html (last visited May 6, 2008).

13. Letter from Radah Butler, President & Suzanne Goldstein Baker, Gen. Counsel, IPX1031, to The Honorable Donald L. Korb, Chief Counsel, IRS (May 3, 2006), *in* TAX NOTES TODAY, May 15, 2006, *available at* 2006 TNT 93-48 (Lexis) [hereinafter IPX1031 Letter].

14. *See id.*

15. The several hundred qualified intermediaries that are members of the Federation of Exchange Accommodators (FEA) are listed on the FEA's website. FEA, Member/QI Locator, http://www.1031.org/memberlocator/index.asp (last visited May 6, 2008). In addition to those qualified-intermediary companies, many attorneys, certified public accountants, and others provide qualified-intermediary services, even though they are not members of the FEA. *See* BORDEN, *supra* note 5, at 22–25 (describing the various types of qualified intermediaries).

16. IPX1031 is the self-proclaimed largest qualified intermediary in the country. *See* IPX1031 Letter, *supra* note 13. Therefore, other qualified intermediaries will not facilitate the volume of exchanges that IPX1031 facilitates. Nonetheless, the several hundred other qualified intermediaries likely facilitate tens of thousands of exchanges each year.

exchangers were individuals.[17] The other significant class of exchangers—partnerships, limited liability companies, and trusts—constituted 24% of the total exchangers.[18] Because many individuals form limited partnerships or limited liability companies through which they own property,[19] undoubtedly individuals comprise a significant portion of that class of exchangers. The remaining 6% of exchangers were corporations.[20] Thus, individuals constitute the vast majority of taxpayers exchanging property under section 1031.

The financial information in the IPX1031 Letter also indicates the breadth of section 1031's popularity. The median amount of exchange proceeds received by IPX1031 for an exchange was $220,000.[21] Based on the 31,000 exchanges facilitated by IPX1031, a conservative estimate of IPX1031's exchange volume is about $7 billion.[22] Extrapolating this amount to include all of the exchanges facilitated by the hundreds of other qualified intermediaries manifests that section 1031 exchanges amount to tens of billions (if not hundreds of billions) of dollars in annual exchanges. This amount rivals the country's annual private-equity commitments.[23] Such activity demonstrates that section 1031 plays an important role in the United States' tax law and economy.[24]

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17. *See* IPX1031 Letter, *supra* note 13.

18. *Id.*

19. A primary motivation, besides tax reasons and management flexibility, for owning property through limited partnerships and limited liability companies is the liability protection that such entities provide their owners. *See, e.g.*, Rebecca J. Huss, *Revamping Veil Piercing for All Limited Liability Entities: Forcing the Common Law Doctrine into the Statutory Age*, 70 U. CIN. L. REV. 95, 96–101 (2001). The members of a limited liability company and the limited partners of a limited partnership are generally not personally liable for any liabilities arising with respect to property owned by the respective legal entities. *Id.* at 101–02.

20. IPX1031 Letter, *supra* note 13.

21. *Id.*

22. This estimate is the product of multiplying the total number of exchanges considered (31,000) by the median value of exchange proceeds received ($220,000), rounded to the nearest billion. The estimate is conservative because the minimum dollar amount received would not be less than zero, but the amount of exchange proceeds received on the largest exchanges could be quite significant. The estimate also does not include the total value of property exchanged because many of the exchange properties will be subject to liability. The amount deposited with IPX1031 in such situations would include only the difference between the fair market value of the property transferred and the liability to which the transferred property was subject. *See id.* Thus, the total dollar value of property exchanged with IPX1031 is probably significantly larger than the $6.82 billion estimate. As further evidence of the conservative nature of the estimate, another exchange company claims to have facilitated about $10 billion of exchanges in 2006. *See* Lattman & Dunham, *supra* note 3.

23. *See* U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES: 2006, at 520 tbl.753 (125th ed. 2006), *available at* http://www.census.gov/prod/2005pubs/06statab/business.pdf (reporting that total private-equity capital in 2004 was $62.244 billion).

24. In contrast, mergers and acquisitions activity was estimated at $1.318 trillion in 2003. *See*

Although section 1031 is popular among property owners, it is the subject of significant academic criticism.[25] The popularity of section 1031 guarantees that it receives significant political support.[26] Yet the political support alone may not explain section 1031's continuance. Tax policy also appears to support section 1031. For example, one commentator has demonstrated that efficiency supports the concept of section 1031, even if efficiency does not support the scope of section 1031.[27] This Article focuses on the other major principle of tax policy—equity. Section 1031 critics claim that section 1031 violates equity; others claim that equity supports section 1031.[28] These contradictory claims highlight the like-kind exchange equity conundrum.

This Article posits that if tax law exempts property appreciation from taxation, then comparative equity obligates tax law to exempt exchanges

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id. at 520 tbl.751. Section 1031 activity is minimal compared to the mergers and acquisitions activity.

25. *See, e.g.*, 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, 717–18, 735–39 (2002) (arguing that horizontal equity (other than perhaps in perception) does not inform the analysis of section 1031 but efficiency suggests that the definition of like-kind property is too broad); Kornhauser, *supra* note 2, at 441–45 (arguing that section 1031 violates both equity and efficiency); Martin J. McMahon, Jr., Commentary, *Rollover Is Better than Section 1031, but Why Stop There?*, 92 TAX NOTES 1111, 1113 (2001) (positing that section 1031 violates equity because it allows taxpayers to exchange only certain types of property and violates efficiency because it affects taxpayers' investment decisions); Steven J. Willis, *Of [Im]permissible Illogic and Section 1031*, 34 U. FLA. L. REV. 72, 72–73 (1981) (criticizing the confused state of the law regarding the definition of exchange prior to the promulgation of the section 1031 deferred-exchange safe-harbor regulations); *see also* Joseph M. Dodge & Jay A. Soled, *Debunking the Basis Myth Under the Income Tax*, 81 IND. L.J. 539, 593 (2006) ("Tax-free like-kind exchanges under Code section 1031 (which mostly occur with respect to investment real estate) not only pose complex basis rules, but even worse present a major opportunity for overstating basis." (footnote omitted)). *But see* Erik M. Jensen, *The Uneasy Justification for Special Treatment of Like-Kind Exchanges*, 4 AM. J. TAX POL'Y 193, 199–215 (1985) (concluding that there is an appeal to treating the exchanger of like-kind property and the holder of property similarly, but recognizing that the stated rationales for section 1031 (continuity of investment, administrative convenience, protection against loss recognition, and economic efficiency) are plagued with weaknesses).

26. In addition to the favorable tax treatment that section 1031 affords to a large cross section of the taxpayer population, section 1031 also provides a living to thousands of tax advisors, lawyers, and exchange accommodators. Each of these constituents supports section 1031. For example, the FEA is politically active in issues related to section 1031. *See* FEA, Industry Leadership, http://1031.org/aboutFEA/leadership.htm (last visited May 6, 2008) (identifying the FEA's political activities on both the state and federal levels).

27. *See* Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 TAX L. REV. 1, 45 (1992) ("The similarity of the items exchanged suggests weaker nontax reasons for exchanging them, and thus a greater likelihood that taxing such exchanges would merely deter them, rather than raise revenue.").

28. *See infra* Part IV.

of like-kind property from taxation. To assert thusly, the Article accepts that in a perfect world tax law should tax income, including accretion, in its broadest sense. Nonetheless, Part V demonstrates that in an imperfect world taxing property owners on the appreciation in value of difficult-to-value and illiquid property would violate equity. Thus, equity generally requires exempting from taxation appreciation in the value of held property. Once the law exempts appreciation in value from taxation, the law should exempt like-kind exchanges from taxation. To provide the necessary background for Part V's analyses and conclusions, this Article first provides a brief overview of section 1031 and equity, and then describes the equity conundrum in detail.

II. OVERVIEW OF SECTION 1031

In concept, section 1031 is simple. In application, it is a bit complex, but the section 1031 industry helps make that complexity manageable. Section 1031 theory, on the other hand, presents a worthy challenge. Section 1031 provides that a property owner may dispose of property tax-free in exchange for like-kind property, if the exchanger held the transferred property and will hold the acquired property for use in a trade or business, or for investment.[29] Thus, section 1031 allows the tax-free transfer of property by exempting from recognition gain or loss that an exchanger realizes on the transfer of property.[30]

The following example illustrates the application of section 1031. Assume that Beatrice owns Property *B*, an office building she purchased three years ago for $50,000 to hold as rental property.[31] When Property *B*

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29. *See* I.R.C. § 1031(a)(1) (2000). The basis rules of section 1031(d) require that the exchanger take a basis in replacement property equal to the basis the exchanger had in relinquished property, adjusted for gain or loss recognized and boot received. *Id.* § 1031(d). Those basis rules defer any gain or loss that an exchanger does not recognize on the exchange. *See* Jensen, *supra* note 25, at 196. As a consequence, section 1031 exchanges are often referred to as tax-deferred exchanges. Nonrecognition of gain or loss on an exchange makes the exchange tax-free. Therefore, section 1031 exchanges are often referred to as tax-free exchanges. Because deferral is not central to this Article's analysis, this Article focuses on the tax-free aspect of section 1031 exchanges.

30. *See* I.R.C. § 1001(c) (providing that taxpayers must recognize realized gain unless a Code provision specifically allows nonrecognition); *id.* § 1031(a)(1) (providing that no gain or loss shall be recognized on the exchange of like-kind property held for productive use in a trade or business, or for investment). As a tax-planning tool, section 1031 is most popular for its deferral of gain recognition. Though section 1031 also defers loss, this Article focuses on gain deferral. For a more in-depth discussion of section 1031, see generally BRADLEY T. BORDEN, TAX-FREE LIKE-KIND EXCHANGES (Civic Research Institute 2008).

31. To simplify the analysis and discussion, this Article assumes that the property's adjusted basis equals its purchase price. This would generally not be the case with an apartment building or other depreciable property because allowable depreciation deductions reduce the property's cost basis. *See id.* § 1011(a) (defining adjusted basis as cost basis determined under section 1012 adjusted as provided in section 1016); *see also id.* § 1012 (providing that basis equals the cost of

is worth $100,000, Eddy offers to transfer Property *E*, an apartment building worth $100,000, to Beatrice in exchange for Property *B*. Beatrice and Eddy exchange properties, after which Beatrice uses Property *E* as a hotel. Assuming the transaction satisfies all of the requirements of section 1031, Beatrice will recognize no gain on the transaction and she will take a $50,000 basis in Property *E*.[32] If Beatrice later sells Property *E* for $50,000 or more in a taxable transaction, she will recognize any gain she deferred on the exchange of Property *B*.[33]

Contrast the tax result of Beatrice's exchange with the tax result of Drew's sale of Property *D*. Drew purchased Property *D*, an office building, three years ago for $50,000. Pam offers to purchase Property *D* from Drew for $100,000 cash. Drew will recognize $50,000 of gain on the sale of Property *D* to Pam.[34] Drew would likely owe tax on the $50,000 of gain that he recognizes.[35] If Drew had exchanged Property *D* for non-like-kind property worth $100,000, he would have similarly recognized $50,000 of gain and probably would have owed tax on the gain. Thus, the tax law treats Beatrice, the exchanger of like-kind property, differently from Drew, the seller of property and the exchanger of non-like-kind property. Section 1031 is therefore not conceptually difficult—if a person satisfies the requirements of section 1031, the person does not recognize taxable gain or loss on the exchange of property.

In practice, section 1031 is more complicated because it applies only to certain types of transactions and specific types of property. Further, the vast majority of transactions that qualify for section 1031 nonrecognition are not simple simultaneous property swaps. Section 1031 applies only to exchanges of certain property, specifically excluding property such as inventory, corporate stock, notes, and interests in partnerships.[36] Commentators suggest that section 1031's broad definition of like-kind real property favors real estate.[37] Yet section 1031 applies generally to all

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property); *id.* § 1016(a)(2)(A) (providing that allowable depreciation reduces a property's basis).

32. *See id.* § 1031(d).

33. For example, if Beatrice sells Property *E* for $120,000 cash three years after the exchange, she will recognize $70,000 of gain ($120,000 of amount realized minus $50,000 of adjusted basis). *See id.* § 1001(a).

34. The gain equals the difference between the $100,000 Drew receives and the $50,000 adjusted basis he has in Property *D*. *See id.* § 1001(a), (c).

35. *See id.* § 61(a)(3) (requiring taxpayers to include gains from dealings in property in gross income). *See generally* I.R.C. § 1 (West 2008) (imposing tax on individuals).

36. *See* I.R.C. § 1031(a)(2) (2000).

37. *See* Martin J. McMahon, Jr., *Individual Tax Reform for Fairness and Simplicity: Let Economic Growth Fend for Itself*, 50 WASH. & LEE L. REV. 459, 479 ("There is no good reason that investors should be able to move among various real estate investments without paying taxes on realized gains when the same privilege is not accorded to reinvestment of sales proceeds in a different investment."); *see also* Brown, *supra* note 25, at 735–40 (arguing that the definition of like-kind real property is too broad and that the categorization rules used for depreciation would

business-use and investment property. Thus, under section 1031, property owners may exchange tangible personal property—such as vehicles and equipment,[38] aircraft,[39] and collectibles[40]—and intangible property such as copyrights,[41] patents,[42] and licenses.[43]

To qualify for nonrecognition under section 1031, the disposition of property must be part of a transaction that satisfies section 1031's definition of "exchange."[44] Section 1031's definition of exchange presents a paradox of strictness and liberalness. Congress and courts strictly interpret the exchange requirement by prohibiting an exchanger's actual or constructive receipt of exchange proceeds.[45] Thus, if an exchanger sells property, receives the sale proceeds, and immediately reinvests the proceeds in like-kind property, the seller will not obtain section 1031 nonrecognition.[46] An exchanger would also lose section 1031 nonrecognition if the exchanger directs sale proceeds to an escrow account or trust that the exchanger controls.[47] Even though the exchanger does not actually receive the proceeds, the exchanger's constructive receipt through

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be more appropriate).

38. *See* Treas. Reg. § 1.1031(a)-2(b) (as amended in 2005); *see also* Rev. Proc. 2003-39, 2003-1 C.B. 971 (providing a safe harbor for like-kind exchange programs that are "ongoing program[s] involving multiple exchanges of 100 or more properties").

39. *See* Treas. Reg. § 1.1031(a)-2(b)(2)(iv) (as amended in 2005).

40. *See* Rev. Rul. 76-214, 1976-1 C.B. 218 (allowing nonrecognition of gain under section 1031 on the exchange of Mexican 50-peso noncurrency bullion-type gold coins for Australian 100-corona noncurrency bullion-type gold coins); Silverman, *supra* note 11 (describing exchanges of baseball memorabilia that the exchanger hoped would qualify for section 1031 nonrecognition).

41. *See* Treas. Reg. § 1.1031(a)-2(c)(3), ex. 1 (as amended in 2005) (providing that a copyright in a novel is like kind to a copyright in a different novel).

42. *See* I.R.S. Tech. Adv. Mem. 200602034 (Jan. 13, 2006) (ruling that two patents are like kind).

43. *See* I.R.S. Tech. Adv. Mem. 200035005 (Sept. 1, 2000) (ruling that the exchange of an FCC radio license for an FCC television license qualified for section 1031 nonrecognition).

44. *See* I.R.C. § 1031(a)(1) (2000).

45. *See, e.g.*, 65 CONG. REC. 2773, 2799 (1924) ("Mr. La Guardia: Under this paragraph is it necessary to exchange property? Suppose the property is sold and other property immediately acquired for the same business. Would that be a gain or loss, assuming there is greater value in the property acquired? . . . Mr. Green of Iowa: If the property is reduced to cash and there is a gain, of course it will be taxed. Mr. La Guardia: Suppose that cash is immediately put back into the property, into the business? Mr. Green of Iowa: That would not make any difference."); Coleman v. Comm'r, 180 F.2d 758, 760 (8th Cir. 1950) ("Petitioner . . . must bring himself squarely within the explicit provisions of the exception there provided for.").

46. *See* Carlton v. United States, 385 F.2d 238, 242–43 (5th Cir. 1967) (holding that the taxpayers' receipt of sale proceeds and immediate reinvestment in like-kind property destroyed the section 1031 exchange, even though the taxpayers clearly intended a section 1031 exchange).

47. *See, e.g.*, Greene v. Comm'r, 62 T.C.M. (CCH) 512 (1991) (finding that the requirements of section 1031 were not satisfied when a taxpayer could withdraw money from trust account without any substantial limitations).

control over the proceeds prohibits section 1031 nonrecognition.[48]

On the other hand, Congress, the courts, and the Treasury liberally apply the exchange requirement by allowing deferred exchanges,[49] multiple-party exchanges,[50] reverse exchanges,[51] and improvements exchanges.[52] A deferred exchange is a transfer of property (the relinquished property) followed some time later by the receipt of other like-kind property (the replacement property).[53] A multiple-party exchange allows an exchanger to transfer relinquished property to one party and to receive replacement property from another party.[54] A reverse exchange

48. *See* Halpern v. United States, 286 F. Supp. 255, 258–59 (N.D. Ga. 1968) (holding that the exchanger's title insurance company's receipt of exchange proceeds disqualified the transaction from section 1031 nonrecognition because the exchanger could request cash payment of the proceeds from the insurance company and thus the exchanger had constructively received the proceeds).

49. *See* I.R.C. § 1031(a)(3) (providing that an exchanger must identify replacement property within forty-five days after transferring relinquished property and generally receive the replacement property within 180 days after transferring the relinquished property); *see also* Starker v. United States, 602 F.2d 1341, 1353–55 (9th Cir. 1979) (granting section 1031 nonrecognition to a multiple-party exchange that took two years to complete).

50. *See, e.g.*, Biggs v. Comm'r, 632 F.2d 1171, 1178 (5th Cir. 1980) (granting section 1031 nonrecognition to an intermediary-facilitated multi-party exchange that involved an advance from the exchanger to the intermediary, as well as the direct deeding of property from the exchanger to the relinquished-property buyer and from the replacement-property seller to the exchanger); W.D. Haden Co. v. Comm'r, 165 F.2d 588, 590 (5th Cir. 1948) (holding that an exchange facilitated by an intermediary involving the direct deeding of property from the exchanger to the relinquished-property buyer and from the replacement-property seller to the exchanger qualified for section 1031 nonrecognition); Mercantile Trust Co. v. Comm'r, 32 B.T.A. 82, 83, 88 (1935) (granting nonrecognition to an exchange facilitated by an intermediary).

51. *See* Rev. Proc. 2000-37, 2000-2 C.B. 308, *modified by* Rev. Proc. 2004-51, 2004-2 C.B. 294 (providing a safe harbor for structuring title-parking reverse exchanges).

52. *See* Coastal Terminals, Inc. v. United States, 320 F.2d 333, 336, 339 (4th Cir. 1963) (holding that an improvements exchange facilitated by a third party qualified for section 1031 nonrecognition).

53. *See* I.R.C. § 1031(a)(3) (allowing 180 days to elapse between when the exchanger initially transfers relinquished property and subsequently acquires replacement property); *see also Starker*, 602 F.2d at 1353–55 (granting section 1031 nonrecognition to a transfer of relinquished property even though the exchanger did not acquire replacement property until two years later); Treas. Reg. § 1.1031(k)-1(a) (as amended in 2002) ("For purposes of section 1031 and this section, a deferred exchange is defined as an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the 'relinquished property') and subsequently receives property to be held either for productive use in a trade or business or for investment (the 'replacement property').").

54. *See W.D. Haden Co.*, 165 F.2d at 590 (holding that an intermediary-facilitated sale of relinquished property to one party and acquisition of replacement property from another party qualified for nonrecognition, even though the facilitator did not take title to either property); *Mercantile Trust Co.*, 32 B.T.A. at 83, 88 (holding that an intermediary-facilitated sale of relinquished property to one party and acquisition of replacement property from another party qualified for nonrecognition under the predecessor to section 1031); Treas. Reg. § 1.1031(k)-1(g)

allows an exchanger to acquire replacement property before disposing of relinquished property.[55] An improvements exchange allows an exchanger to use proceeds from the sale of relinquished property to construct improvements on replacement property.[56] Each of the various exchange structures may require significant planning and generally require the services of a qualified intermediary or other exchange facilitator.[57]

To qualify for section 1031 nonrecognition, the relinquished property and replacement property must be like kind.[58] Properties of the same nature and character are like kind.[59] Under the nature and character test, many types of interests in real property are like kind, but case law and IRS rulings reveal that not all real property is like kind.[60] Real property generally is not of the same nature and character as personal property; thus these properties are not like kind.[61] Because of the varied nature of personal property, the section 1031 regulations provide classification safe-

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(as amended in 2002) (providing several safe harbors for structuring multiple-party exchanges).

55. *See* Rev. Proc. 2000-37, 2000-2 C.B. 308 (providing a safe harbor for structuring title-parking reverse exchanges). *See generally* Borden, *supra* note 2, at 659 (discussing the title-parking reverse-exchange safe harbor and theoretical support for "pure" reverse exchanges).

56. *See generally* Bradley T. Borden, *Recent Developments in Build-to-Suit Exchanges*, 44 TAX MGMT. MEMORANDUM 19 (2003) (reviewing the legal support for improvements exchanges (also referred to as build-to-suit exchanges) and describing the various improvements-exchange structures).

57. *See generally* BORDEN, *supra* note 5, at 99–192 (describing the various exchange structures).

58. *See* I.R.C. § 1031(a)(1).

59. Treas. Reg. § 1.1031(a)-1(b) (as amended in 1991).

60. *See, e.g.*, Comm'r v. P.G. Lake, Inc., 356 U.S. 260, 268 (1958) (holding that exchanges of oil payment rights for other real property do not qualify for like-kind treatment); Wiechens v. United States, 228 F. Supp. 2d 1080, 1085 (D. Ariz. 2002) (holding that a water right that constituted an interest in property under Arizona law was not like kind to other real property); Capri, Inc. v. Comm'r, 65 T.C. 162, 181–82 (1975) (holding that a sale–leaseback did not qualify for section 1031 nonrecognition where the lease was for ten years); Oregon Lumber Co. v. Comm'r, 20 T.C. 192, 197–98 (1953) (stating that even if the right to cut timber constituted real property under the laws of Oregon, the court would not be bound to hold that the right was like kind to other real property); Kimbell v. Comm'r, 41 B.T.A. 940, 951 (1940) (holding that an oil payment right did not qualify for like-kind treatment when it was exchanged for interest in another oil lease, leasehold equipment, and other personal property); Midfield Oil Co. v. Comm'r, 39 B.T.A. 1154, 1156–58 (1939) (holding that an oil payment is not like kind to an overriding royalty interest). *See generally* Bradley T. Borden, *The Whole Truth About Using Partial Real Estate Interests in Section 1031 Exchanges*, 31 REAL EST. TAX'N 19, 19–32 (2003) (discussing the case law and rulings that reveal that different real property interests are not like kind to other real property).

61. *See* Rev. Rul. 72-151, 1972-1 C.B. 225 (ruling that the exchange of real property for real property and machinery is not an exchange solely for like-kind property). *But see* Kelly E. Alton & Bradley T. Borden, *Transforming Personal Tangible and Intangible Property into Real Property*, 34 REAL EST. TAX'N 52, 53–56 (2007) (identifying situations in which personal property may be bundled with real property interests and become like kind to other personal property).

harbor rules for determining which personal properties are like kind.[62] Thus, the like-kind-property requirement limits the application of section 1031.

Section 1031 also requires exchangers to hold the relinquished property and replacement property "for productive use in a trade or business or for investment."[63] Thus, an exchange of personal-use property, such as a personal residence, does not qualify for section 1031 nonrecognition.[64] Section 1031 also specifically excludes exchanges of other property. For example, exchanges of inventory,[65] corporate stock,[66] notes,[67] and partnership interests[68] do not qualify for section 1031 nonrecognition.

For the uninitiated, applying section 1031 may be daunting. As implied above, however, the section 1031 industry has developed practices that simplify the exchange process and spread the costs of exchanging over thousands of exchanges.[69] Thus, the industry helps minimize the complexity of applying section 1031. The real challenge that section 1031 presents is the equity conundrum.

III. OVERVIEW OF CONCEPTS OF EQUITY

Tax policy uses the term "equity" to refer to the concept that "people with equal capacity [should] pay the same [amount of tax]."[70] Stated differently, "Units with the same level of well-being should be liable for identical taxes or transfers,"[71] or "equals [should] be treated equally."[72]

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62. *See* Treas. Reg. § 1.1031(a)-2 (as amended in 2005) (providing safe harbors for personal property that comes within the same "General Asset Class" or "Product Class").

63. I.R.C. § 1031(a)(1).

64. *See* Moore v. Comm'r, 93 T.C.M. (CCH) 1275 (2007), *available at* 2007 WL 1555852, at *12–13 (holding that an exchange of a vacation home does not qualify for section 1031 nonrecognition). *But see* Rev. Proc. 2005-14, 2005-1 C.B. 528 (providing rules for applying section 1031 and section 121 to property used as both a principal residence and a business property).

65. I.R.C. § 1031(a)(2)(A).

66. *Id.* § 1031(a)(2)(B).

67. *Id.*

68. *Id.* § 1031(a)(2)(D).

69. *Cf. supra* text accompanying notes 12–24 (discussing the reported volume of one large exchange company).

70. *See* RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 223 (5th ed. 1989). This definition refers to horizontal equity and is based on an abilities theory. Equity may also be based on a benefits theory, under which "each taxpayer would be taxed in line with his or her demand for public services." *Id.* at 220. As discussed below, the appropriate theory is a matter of debate and presents one of the difficulties of using equity as an analytical tool. *See infra* text accompanying notes 182–88. To set the stage for the discussion of equity, this Article accepts the abilities theory.

71. Robert Plotnick, *The Concept and Measurement of Horizontal Inequity*, 17 J. PUB. ECON. 373, 374 (1982).

72. Louis Kaplow, *Horizontal Equity: Measures in Search of a Principle*, 42 NAT'L TAX J.

That concept is not unique to tax policy. In fact, the tax policy concept of equity most likely derives from the moral and philosophical discussions of equity and equality. Although the term "equality" finds greater use in moral and philosophical discussions, this Article, to stay consistent with tax scholars' general terminology, uses the term "equity" to refer to the concept that likes should be treated alike.

This Article distinguishes substantive equity (treating likes alike and ensuring just laws) from procedural equity.[73] Procedural equity refers to a judiciary's ruling in the absence of law or against law based upon principles that appear to produce a just result.[74] Focusing on whether the law treats similarly situated people similarly, this Article addresses substantive, not procedural, equity.

A. *Aristotelian Concept of Equity*

The tax policy concept of equity relates to the philosophical concept, the origin of which is attributed to Aristotle: "[Equity] in morals means this: things that are alike should be treated alike, while things that are unalike should be treated unalike in proportion to their unalikeness."[75]

139, 139 (1989).

73. *See* MARK W. JANIS, AN INTRODUCTION TO INTERNATIONAL LAW 67, 75 (4th ed. 2003) (identifying the distinction between procedural and substantive equity in international law).

74. *See id.* at 70 (recognizing that procedural equity may allow a judge to act "*intra legem*, that is, within the law . . . as to achieve the law's intent . . . . *praeter legem*, that is, beyond the law . . . to fill in gaps and supplement the law with equitable rules . . . . [or] *contra legem*, that is, against the law . . . [to achieve] an equitable result . . . despite the law's explicit injunction"). The type of equity that Professor Janis refers to as procedural equity is the type of equity recognized by English law. *See* GEORGE TUCKER BISPHAM, THE PRINCIPLES OF EQUITY 1 (Joseph D. McCoy ed., 11th ed. 1931) ("Equity, in its technical and scientific legal sense, means neither natural justice nor even all that portion of natural justice which is susceptible of being judicially enforced. It has, when employed in the language of English law, a precise, definite and limited signification, and is used to denote a system of justice which was administered in a particular court . . . ."); BLACK'S LAW DICTIONARY 579 (8th ed. 2004) ("[E]quity . . . . 3. The recourse to principles of justice to correct or supplement the law as applied to particular circumstances <the judge decided the case by equity because the statute did not fully address the issue>.").

75. Peter Westen, *The Empty Idea of Equality*, 95 HARV. L. REV. 537, 542–43 (1982) (attributing the origin of the study of equality and the articulated statement of equality to Plato and Aristotle). Aristotle was, however, less direct in his statement: "[I]f they are not equal, they will not have what is equal, but this is the origin of quarrels and complaints—when either equals have and are awarded unequal shares, or unequals equal shares." ARISTOTLE, NICOMACHEAN ETHICS bk. V ch. 3, at 112 (J.L. Ackrill & J.O. Urmson eds., W.D. Ross trans., Oxford Univ. Press 1998). John Stuart Mill used the term equality in discussing tax policy, recognizing that equality applies to all laws, including tax laws. *See* JOHN STUART MILL, PRINCIPLES OF POLITICAL ECONOMY 735 (Prometheus Books 2004) (1848) ("For what reason ought equality to be the rule in matters of taxation? For the reason, that it ought to be so in all affairs of government. As a government ought to make no distinction of persons or classes in the strength of their claims on it, whatever sacrifices it requires from them should be made to bear as nearly as possible with the same pressure upon all;

Moral and legal philosophers, and economists have devoted significant thought to the concept of equity and its value as a normative tool. The analytic value of Aristotelian equity depends upon whether it is comparative or merely lexical. Equity can be interpreted as a derivative, lexical, and descriptive concept—lexical equity.[76] Or equity can be interpreted as an essential, substantive (or comparative), and prescriptive concept—comparative equity.[77] Lexical equity has no normative significance, but comparative equity does.[78]

Two simple examples illustrate the difference between lexical equity and comparative equity.[79] First, assume Patti—the parent of three children, Mork, Mindy, and Magnum—tells the children, "I will take all of my children to the movie on Friday." This rule illustrates lexical equity. Each child is one of Patti's children, and, as such, each child has a right to go to the movie with Patti on Friday. The children are alike in being children of Patti. That likeness, however, does not determine their rights under the rule. Instead the rule itself determines their rights.[80] Lexical equity is merely derivative, descriptive, and tautological because comparing Mindy to Mork to determine her rights to go to the movie adds nothing to the analysis.[81]

Second, assume Patti tells her children, "Next time I take Mork to the movies, I will take Mindy and Magnum." This rule illustrates comparative equity. Mindy and Magnum can determine their right to go to the movie only by comparing themselves to Mork.[82] Lexical equity does not answer the like-kind exchange equity conundrum, but comparative equity informs the equity analysis and helps solve the conundrum. Thus, this Article relies on comparative equity. But merely comparing parties does not always satisfy an equity analysis; higher principles of equity may be necessary to complete the analysis.

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which, it must be observed, is the mode by which least sacrifice is occasioned on the whole."). As discussed below, equity has become the preferred term in tax analysis. *See infra* Part III.C.

76. *See* Kenneth W. Simons, *Equality as a Comparative Right*, 65 B.U. L. REV. 387, 393–94 (1985).

77. *Id.*

78. *Id.* at 394.

79. Professor Simons used these examples to explain the concepts of lexical and comparative equity. *Id.*

80. *Id.* at 397.

81. *Id.* at 393, 397.

82. *Id.* at 397–98.

B. *Rawlsian Concept of Equity*

Merely applying rules uniformly to people who are alike may result in consequences that violate our sense of right and wrong. For example, forced segregation of swimming pools in the city of Jackson, Mississippi, would deny African-Americans equal protection of the laws.[83] Because African-Americans are not unlike other races in their desire to enjoy a refreshing swim on a hot afternoon in Mississippi, Aristotelian equity, in its simplest form, requires the city to treat African-Americans the same as others. The city could have satisfied Aristotelian equity either by closing the swimming pool to all people or by opening it to all people. The city decided to do the former and closed the pool.[84] Closing the pool violates our sense of right and wrong because it treats members of a particular race as inferior.[85] The Supreme Court eventually implicitly recognized that closing the pool to prohibit a particular group of people from swimming results in unequal treatment because the closing stigmatizes that group.[86]

The Supreme Court's eventual interpretation of equity incorporates more than mere comparisons and similar treatment. This interpretation provides a basis for defending equity as an independent norm. The Aristotelian concept of equity, in its simplest form, does not recognize that distinction. The Rawlsian concept of equity, however, provides direction for distinguishing between simple comparisons and meaningful comparisons. In particular, it helps establish the criteria that should determine whether parties are like or unlike.

Rawls provides that equity "is defined by the first principle of justice and by such natural duties as that of mutual respect; it is owed to human beings as moral persons."[87] Stated differently, "The essence of [equity] that matters in America is the idea that 'one person is as good as another,' that each of us is a respected participant in the society, a member who counts for something."[88] Under the Rawlsian concept of equity,

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83. *See* Clark v. Thompson, 206 F. Supp. 539, 542 (S.D. Miss. 1962) (holding that although enforced segregation would deny equal protection of the laws, the plaintiffs were not entitled to an injunction on the facts of the case), *aff'd*, 313 F.2d 637, 637–38 (5th Cir. 1962), *cert. denied*, 375 U.S. 951 (1963); *see also* Palmer v. Thompson, 403 U.S. 217, 218–19 (1971) (providing the facts of the *Clark* case).

84. *See Palmer*, 403 U.S. at 219. The Court upheld the closing against an equal protection challenge, explaining that the closing denied access to all and thus treated all alike. *Id.* at 219–21, 226. *But see* Griffin v. County Sch. Bd., 377 U.S. 218, 225, 230–31 (1964) (holding that the closing of public schools to maintain segregation violated the Equal Protection Clause).

85. *See* Westen, *supra* note 75, at 590.

86. *See id.* at 590–91 (citing Washington v. Davis, 426 U.S. 229, 244 n.11 (1976)).

87. JOHN RAWLS, A THEORY OF JUSTICE 447 (rev. ed. 1999).

88. Kenneth L. Karst, *Why Equality Matters*, 17 GA. L. REV. 245, 272 (1983). We see examples of this in modern culture. Bill Gates recently used equity as the theme of his remarks given at a Harvard commencement. Gates said:

stigmatizing a group of people or creating a caste system violates equity because such actions differentiate groups and treat some people as not quite human, representing a breakdown of justice and empathy.[89] This assessment recognizes a weakness of the Aristotelian concept of equity. If a caste system groups likes in similar classes based on some criteria, rules that apply to one class but not another might not violate the Aristotelian concept of equity.[90] Such rules would, however, violate the Rawlsian concept of equity because they represent a breakdown of empathy. "[I]t means that some are considered inferior, treated as though they deserve less."[91] By rejecting such treatment, the Rawlsian concept of equity solves some of the difficulties that the Aristotelian concept of equity poses.

Although requiring empathy and recognition of others' dignity, the Rawlsian concept of equity does not appear to require equal economic status. One commentator suggested that "Americans accept wide disparities in wealth and income, so long as the system remains open and people at the bottom of the economic scale are relieved from the kinds of deprivation that stigmatize or exclude them from participation in society."[92] Thus, if tax law closes the system to people at the bottom of the

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> But humanity's greatest advances are not in its discoveries—but in how those discoveries are applied to reduce inequity. Whether through democracy, strong public education, quality health care, or broad economic opportunity—reducing inequity is the highest human achievement.
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> . . . .
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> . . . I hope you will judge yourselves not on your professional accomplishments alone, but also on how well you have addressed the world's deepest inequities . . . [and] on how well you treated people a world away who have nothing in common with you but their humanity.

William Henry Gates III, Remarks of Bill Gates: Harvard Commencement (June 7, 2007), *in* HARV. U. GAZETTE ONLINE, June 7, 2007, http://www.news.harvard.edu/gazette/2007/06.14/99-gates.html (second ellipsis in original).

89. *See* RAWLS, *supra* note 87, at 444 ("Equality of consideration puts no restrictions upon what grounds may be offered to justify inequalities. There is no guarantee of substantive equal treatment, since slave and caste systems (to mention extreme cases) may satisfy this conception. The real assurance of equality lies in the content of the principles of justice and not in these procedural presumptions."); Karst, *supra* note 88, at 249 ("Stigma dissolves the human ties we call 'acceptance' and excludes the stigmatized from 'belonging' as equals. Stigma represents the breakdown of empathy. . . . [I]t is the imposition of this status inequality itself that is harmful.").

90. *See* Westen, *supra* note 75, at 572–74. For example, if people are divided into two groups, men and women, so long as the laws applicable to men apply to all men and the laws applicable to women apply to all women, the laws should not violate Aristotelian equality, even if the laws put one group above the other. As discussed below, one difficulty in applying Aristotelian equality is determining the criteria that create the class of likes. *See infra* Part V.A.

91. MARTIN LUTHER KING, JR., I HAVE A DREAM: WRITINGS & SPEECHES THAT CHANGED THE WORLD 45 (James Melvin Washington ed., 1992).

92. Karst, *supra* note 88, at 262–63.

economic scale, then that law would violate the Rawlsian concept of equity. Tax law could do this by burdening those in lower tax brackets to prevent them from accumulating wealth and increasing discretionary income. The Rawlsian concept of equity does not, however, require that tax law equalize income. Rawlsian equity also may not solve some of the other problems in Aristotelian equity. For example, Rawlsian equity does not specifically establish the appropriate criteria for determining the best location for the equity split that the realization requirement causes.[93]

C. *Economic Concept of Equity*

Equity is an important part of tax policy and the analysis of tax laws.[94] Tax policy divides equity into two subcategories: horizontal equity and vertical equity. Horizontal equity requires that "similar persons should be treated similarly."[95] In other words, horizontal equity requires that likes be treated alike.[96] Vertical equity "call[s] for an appropriate differentiation among unequals."[97] In other words, vertical equity requires that unalikes be treated unalike in proportion to their unalikeness.[98] To some extent, vertical equity incorporates the Rawlsian concept of equity. As one commentator stated, vertical equity "is a matter of social taste and political debate."[99] More particularly, vertical equity informs the analysis and debate of the proper distribution of income,[100] which would not treat any group of people as inferior.

This Article focuses primarily on horizontal equity. Although vertical equity raises significant concerns, it does not figure prominently in discussions about section 1031.[101] Tax scholars have used horizontal equity

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93. *See infra* Part V.A (considering the appropriate criteria for applying an equity analysis to section 1031 exchanges in a regime that adopts the realization requirement).

94. *See* HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 30 (1938) ("[W]e may say that tax burdens should bear similarly upon persons whom we regard as in substantially similar circumstances, and differently where circumstances differ."); Richard A. Musgrave, *ET, OT and SBT*, 6 J. PUB. ECON. 3, 4 n.2 (1976) (recognizing that Simons differentiated between horizontal equity and vertical equity without using such terms explicitly).

95. A.C. PIGOU, A STUDY IN PUBLIC FINANCE 5 (3d rev. ed. 1962) (emphasis omitted); *accord* HARVEY S. ROSEN & TED GAYER, PUBLIC FINANCE 367 (8th ed. 2007) ("People in equal positions should be treated equally."); Richard A. Musgrave, *Horizontal Equity, Once More*, 43 NAT'L TAX J. 113, 113 (1990) (describing horizontal equity as "requiring equal treatment of equals").

96. *See supra* note 75 and accompanying text.

97. Musgrave, *supra* note 95, at 113.

98. *See supra* note 75 and accompanying text.

99. Musgrave, *supra* note 95, at 113.

100. *See* ROSEN & GAYER, *supra* note 95, at 358 ("[A tax system] should distribute burdens fairly across people with different abilities to pay.").

101. Vertical equity requires tax law to "distribute burdens fairly across people with different

as a basis of analysis for years.[102] Horizontal equity has critics and difficulties, but it plays an important role in tax policy.[103] Critics of horizontal equity, like critics of equity in general, claim that horizontal equity has no independent normative significance.[104] Using irrelevant criteria also limits the utility of horizontal equity.[105] Nonetheless, horizontal equity may have independent normative significance in a second-best setting to demonstrate a comparative right.[106]

Because the most significant part of this Article relies upon horizontal equity, the Article uses the term equity to refer to horizontal equity. This Article uses vertical equity to draw an appropriate distinction when necessary.

IV. LIKE-KIND EXCHANGE EQUITY CONUNDRUM

The different views of section 1031's critics and supporters reveal the like-kind exchange equity conundrum. Critics of section 1031 claim that it violates equity.[107] Proponents of section 1031 claim that equity justifies section 1031.[108] Both groups cannot be correct. Before solving the equity conundrum, this Article identifies the claims that section 1031 violates equity and the claims that equity supports section 1031.

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abilities to pay." ROSEN & GAYER, *supra* note 95, at 358. Determining a fair distribution across people with different abilities to pay is difficult. *See* MUSGRAVE & MUSGRAVE, *supra* note 70, at 228–31 (discussing different alternatives for measuring ability to pay). A vertical-equity analysis of section 1031 may consider whether people with greater ability to pay hold significant property that qualifies for section 1031 treatment. If so, they may be able to reduce their tax burdens through section 1031 more than taxpayers with less ability to pay are able to do. That possible inequity warrants further study and analysis. This Article's focus on horizontal equity does not present the opportunity to consider section 1031's effect on vertical equity.

102. *See, e.g.*, SIMONS, *supra* note 94, at 30; Joseph T. Sneed, *The Criteria of Federal Income Tax Policy*, 17 STAN. L. REV. 567, 574–80 (1965) (identifying and describing horizontal equity as a criterion of federal tax policy).

103. *See* ROSEN & GAYER, *supra* note 95, at 369 ("We are forced to conclude that horizontal equity, however defined, is a rather amorphous concept. Yet it has enormous appeal as a principle of tax design. Notions of fairness among equals, regardless of their vagueness, will continue to play an important role in the development of tax policy.").

104. *See, e.g.*, Kaplow, *supra* note 72, at 141, 148 (arguing that horizontal equity lacks independent significance); *see also* David Elkins, *Horizontal Equity as a Principle of Tax Theory*, 24 YALE L. & POL'Y REV. 43, 46 (2006) ("[H]orizontal equity can only be justified within the framework of a theory of social justice that accepts the morality of the market distribution.").

105. *See infra* Part V.A (discussing the inadequacy of horizontal equity if applied with irrelevant criteria).

106. *See* Musgrave, *supra* note 95, at 117–20 (demonstrating how horizontal equity works in second-best settings to determine the more appropriate tax based on change in welfare cost).

107. *See infra* Part IV.A.

108. *See infra* Part IV.B.

A. *Claims that Section 1031 Violates Equity*

Critics of section 1031 use equity in several arguments against section 1031. These critics argue that section 1031 violates equity by granting nonrecognition to exchanges of like-kind property while tax law generally taxes gain on the sale of property and immediate reinvestment of sale proceeds in like-kind property.[109] They claim that section 1031 violates equity because it grants nonrecognition to exchanges of like-kind property but does not provide the same treatment to other barter transactions.[110] Critics claim that section 1031 favors investment in real estate by allowing property owners to move among various types of real estate investments tax free, but the same benefit does not extend to other types of investments.[111]

Section 1031 critics also apply an equity analysis to discredit the enumerated purposes of section 1031. One purported justification of section 1031 is that valuing property can be difficult, and therefore swaps of property should not be taxed.[112] The critics argue that the inability-to-value justification is invalid under an equity analysis because the valuation concerns would also be present in exchanges involving boot, but the receipt of boot triggers gain.[113] The critics' argument also recognizes that other provisions in tax law also require gain recognition even though valuation may be difficult.[114] For example, tax law generally requires service providers to include in gross income the fair market value of property received in exchange for services.[115]

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109. *See* McMahon, Jr., *supra* note 37, at 478–79 (recommending that Congress repeal section 1031 to "significantly enhance horizontal equity, make tax burdens more closely correspond with true economic ability to pay, and increase tax revenues to deal with the budget deficit and other priorities").

110. *See id.*

111. *See* McMahon, Jr. *supra* note 25, at 1113.

112. *See* H.R. REP. NO. 73-704, at 13 (1934), *reprinted in* 1939-1 C.B., pt. 2, at 554, 564 ("If all exchanges were made taxable, it would be necessary to evaluate the property received in exchange in thousands of horse trades and similar barter transactions each year.... The committee does not believe that the net revenue which could thereby be collected, particularly in these years, would justify the additional administrative expense.").

113. *See* Kornhauser, *supra* note 2, at 443–44; *see also* I.R.C. § 1031(b) (2000) (requiring an exchanger to recognize realized gain to the extent of boot received in an exchange).

114. *See* Kornhauser, *supra* note 2, at 444.

115. *See* I.R.C. § 83(a) (requiring service providers to include in gross income the fair market value of property received in exchange for services at the time that the property is transferable and not subject to a substantial risk of forfeiture); Treas. Reg. § 1.61-2(d)(1) (as amended in 2003) (requiring the service provider to include in gross income the fair market value of property received in exchange for services). *But see* William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1142 (1974) (recognizing the valuation difficulties

Another purported purpose of section 1031 lies in the ability-to-pay rationale, which provides that taxing an exchanger would cause an undue hardship because the exchanger might have to liquidate the investment to pay taxes.[116] The equity argument against the ability-to-pay rationale contends that because tax law ignores the inability to pay in other contexts, it should ignore the inability to pay in the like-kind exchange context.[117]

Promoting economic efficiency and stimulating the economy are other stated rationales for section 1031.[118] Such rationales provide in part that section 1031 reduces "lock-in" (i.e., the desire to hold property rather than sell it and pay taxes on recognized gain).[119] The equity argument against the lock-in theory contends that other property owners face lock-in but, at most, receive favorable capital-gains rates, not nonrecognition.[120]

Critics of section 1031 also argue that it violates vertical equity by removing the income of wealthy taxpayers from the tax base, resulting in a regressive tax system.[121] Section 1031 creates a regressive tax system because wealthy people hold property that they can exchange tax-free under section 1031, but other taxpayers do not hold such property. Therefore, wealthy people defer taxation. On the other hand, people who are not wealthy cannot defer taxation because they do not own property that qualifies for section 1031 treatment. As a result, people who are not wealthy must pay tax on all of their income. Because section 1031 removes income from the tax base of wealthy people, the wealthy do not pay tax on a significant portion of their income while the less wealthy pay tax on all of their income.

B. *Claims that Equity Supports Section 1031*

The primary justification for section 1031 lies in continuity of investment, [122] and equity supports continuity of investment. The Second

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that arise in property-for-services transactions).

116. *See* Jensen, *supra* note 25, at 203.

117. *See* Kornhauser, *supra* note 2, at 443 (presenting the receipt of property for services, non-like-kind exchanges, and estate taxes as examples of taxation that require payment despite potential difficulties for the taxpayer).

118. *See* Jensen, *supra* note 25, at 213–14.

119. *See id.*

120. *See* Kornhauser, *supra* note 2, at 444–45 (recognizing that pre-1986 tax law provided favorable capital-gains rates). Professor Kornhauser also recognized that Congress eliminated many tax shelters as part of the Tax Reform Act of 1986 but did not consider section 1031. *Id.* at 445. According to Professor Kornhauser's equity argument, Congress's decision to close down other tax shelters but to leave section 1031 untouched and unexamined does not make sense. *Id.*

121. *See id.* at 444 ("As such, [section 1031] violates our concept of vertical equity. People with greater wealth (but tied up in the like-kind investments) pay less tax than those with less wealth.").

122. *See id.* at 407. Several different justifications have been advanced through the years as

Circuit stated that Congress, in enacting the like-kind exchange provision, "was primarily concerned with the *inequity*, in the case of an exchange, of forcing a taxpayer to recognize a paper gain which was still tied up in a continuing investment of the same sort."[123] This apparently articulates the first judicial argument that equity supports section 1031. The section 1031 equity argument compares a person who exchanges property (an exchanger) with a person who remains invested in a single piece of property (a holder).[124] A holder generally does not owe tax on the value of the property's appreciation.[125] The equity argument provides that the tax law should treat exchangers and holders similarly, if the exchanger exchanges for similar property.[126]

To appropriately compare an exchanger to a holder, the analysis examines the exchanger's position before and after the exchange.[127] Before the exchange, the exchanger holds property. If, after the exchange, the

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Congress, courts, and commentators have struggled to understand section 1031 and its place in the tax system. *See id.* at 407–11 (identifying and refuting efficiency (section 1031 facilitates business re-adjustments), administrative convenience (valuation difficulties), and illiquidity (value tied up in illiquid investments) as other stated justifications for section 1031). Although some of the other stated justifications may have been valid at different points in the history of section 1031, continued investment and efficiency remain the strongest justifications. *See* Jordan Marsh Co. v. Comm'r, 269 F.2d 453, 456 (2d Cir. 1959) (identifying continued investment as Congress's true intent for providing nonrecognition to like-kind exchanges); Jensen, *supra* note 25, at 199 ("The strongest justification for nonrecognition is based on the proposition that, after a like-kind exchange, the taxpayer's position is very close to what it was prior to the exchange."). Because many section 1031 exchanges are multiple-party exchanges, *see supra* note 54, valuation is no longer an issue. Exchangers sell property to one party and purchase property from another party. If both transactions are arm's-length transactions, the IRS and the exchanger could easily value the relinquished and replacement properties.

123. *Jordan Marsh Co.*, 269 F.2d at 456 (emphasis added).

124. *See* Kelly E. Alton, Bradley T. Borden & Alan S. Lederman, *Related-Party Like-Kind Exchanges*, 115 TAX NOTES 467, 468 (2007) ("Equity is the basic justification for section 1031's continued-investment purpose. . . . That provision subjects an exchanger of like-kind property to the same tax rules that apply to someone who remains invested in property. That's the strongest policy argument for section 1031."). That article appears to be the first to make an explicit equity argument supporting section 1031.

125. This is a result of the realization requirement. *See infra* Part V.C (discussing the realization requirement). There are a few exceptions to the realization requirement under which owners of certain property are taxed under a mark-to-market regime that do not require a realization event. *See* I.R.C. § 1256(a)–(b) (2000) (applying mark-to-market taxation to regulated future contracts, foreign currency contracts, nonequity options, dealer equity options, and dealer securities future contracts).

126. *See* Alton, Borden & Lederman, *supra* note 124, at 468 ("An exchanger who exchanges property for like-kind property is similar to a taxpayer who does not dispose of property—both remain invested in property and the taxpayer who does not dispose of property does not realize income.").

127. *See id.* at 468–70 (applying a before-and-after test to exchanges to determine whether an exchanger's tax position changes as a result of the exchange).

exchanger holds similar property, the exchanger will be in a position similar to that of a holder, but for the exchange. As such, the exchanger should be subject to the same tax treatment as the holder.

A simple example demonstrates the equity argument as applied to the definition of like-kind property. Assume Aladdin owns Property *A*, a hotel, which he purchased on January 1 for $50,000. On December 31, Property *A* is worth $100,000. Because of the realization requirement, Aladdin does not owe tax on Property *A*'s increase in value.[128] Beatrice owns Property *B*, an office building, which she purchased on January 1 for $50,000. Pam, a real estate developer, plans to develop the part of town where Property *B* is located. She offers to purchase Property *B* from Beatrice for $100,000. Beatrice wishes to continue to own and manage an office building but does not want to frustrate Pam's development plans. Therefore, on December 31, Beatrice transfers Property *B* to Pam in exchange for Property *D*, another office building, which is worth $100,000.[129]

After the exchange, Beatrice is in substantially the same position as she was in before the exchange.[130] Before the exchange, Beatrice owned an office building, and after the exchange she owns an office building. She never actually or constructively received the proceeds from the sale of Property *B*. Because Beatrice's situation did not change substantially as a result of the exchange, her situation is very similar to Aladdin's situation. Aladdin did not pay tax on the appreciation in value of Property *A*; thus, equity suggests that similarly situated Beatrice should not pay tax on the increase in the value of her investment.[131]

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128. *See* Jensen, *supra* note 25, at 199–200 ("[B]ut mere appreciation or depreciation has never been included, to any significant extent, in the Internal Revenue Code's computation of gross income." (footnote omitted)).

129. Even if Pam cannot facilitate Beatrice's exchange, Pam could structure the transaction using a qualified intermediary, allowing her to carry out the exchange without coming into actual or constructive receipt of exchange proceeds. *See* Treas. Reg. § 1.1031(k)-1(g)(4) (as amended in 2002).

130. A mantra in the real estate industry provides that the three most important things in real estate are location, location, location. Because Beatrice exchanges her office building for a building located somewhere else, some may argue that her situation has changed. For example, exchanging an office building in Manhattan, Kansas, for an office building in Manhattan, New York, would cause a significant change in Beatrice's position. Such a transaction would also likely require a significant capital infusion by Beatrice. Though location may be important in real estate, two pieces of real estate with similar value may have similar expectations for value increases and income streams, which should be reflected in the properties' values. Thus, an exchange of properties with similar values would not cause a significant change in the exchanger's position, regardless of the properties' locations.

131. *See* Jensen, *supra* note 25, at 202–03 ("Nevertheless, unrealized appreciation and like-kind exchanges have a fundamental similarity: in neither case is property converted into cash or a cash-equivalent. The investment of the taxpayer remains in substantially similar, illiquid property.").

This argument appears reasonable in the relatively simple situation of an exchange of one office building for another office building. It does not, however, provide much guidance in more complex cases. For example, should tax law treat Beatrice and Aladdin the same if Beatrice acquires an apartment complex instead of another office building? What if Beatrice transfers Property *B* in exchange for a vacant lot or farmland? Beatrice would appear to have altered her position by exchanging for property that is different from her office building. She would appear to be in a situation different from Aladdin's position of continued investment. The equity analysis must, however, compare Beatrice under these various exchange scenarios to Aladdin, who does not sell his property but instead changes the grade of his property through demolition and construction.

Consider the tax consequences to Aladdin if he were to raze the hotel building on Property *A* and construct a warehouse on that property. Aladdin would add the costs incurred to raze the hotel building to the basis of the land on which the building stood.[132] Aladdin would add the costs incurred to construct the warehouse to the basis of the warehouse.[133] As a consequence, Aladdin would neither realize nor recognize either gain or loss on the hotel building demolition or on the warehouse construction.[134] Presumably, the value of the warehouse would be greater than the value of the hotel, otherwise Aladdin would not have incurred the costs to raze the hotel and construct the warehouse. Even though the value of Aladdin's property would increase as a result of his changed circumstances, Aladdin would not realize or recognize gain as a result of the change.

The tax consequences to Aladdin of razing the hotel building and constructing the warehouse provide a basis for considering the proper tax treatment of Beatrice's exchange of Property *B*, an office building, for an apartment complex or other type of improved real property. Tax law allows Aladdin, a holder of property, to transform the improvements on his property tax-free. Therefore, equity suggests that Beatrice should be able to exchange, tax free, her office building for some other type of improved real property.[135]

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132. *See* I.R.C. § 280B (2000) (providing that expenditures incurred to demolish any structure "shall be treated as properly chargeable to capital account with respect to the land on which the demolished structure was located").

133. *See id.* § 1012 (providing that the basis of property includes its cost); *id.* § 1016(a)(1) (providing that taxpayers must increase the basis of property for costs properly charged to a capital account).

134. Razing a building and constructing another is not a realization event. *See id.* § 280B (providing that the cost to raze a building is included in the basis of the land upon which the building stood); *id.* § 1016(a)(1) (requiring taxpayers to add the cost of construction to the basis of existing structures).

135. Assuming Beatrice wishes to dispose of her office building and obtain an apartment complex, an efficiency analysis may suggest that she should not be able to exchange the office

The example of changing a property's use from a hotel to a warehouse illuminates the analysis of an exchange of improved property for unimproved property and the exchange of unimproved property for improved property. Aladdin's razing his hotel would not be a taxable event.[136] The demolition of the hotel would convert Property *A* from improved real property to unimproved real property. Because Aladdin, as a holder of property, can make that conversion tax-free, equity suggests that Beatrice should be able to exchange her office building for raw land tax-free. Similarly, Aladdin can construct a warehouse tax-free. Thus, he is able to convert unimproved land into improved land without paying tax. Under an equity analysis, if Beatrice owned unimproved land, she should be able to convert that unimproved land into improved land through an exchange tax-free.[137] Because the definition of like-kind real property is broad enough to include improved and unimproved real property,[138] section 1031 would treat Beatrice's exchange of Property *B* for raw land the same as Aladdin's demolition of his hotel. Section 1031 supporters recognize this as equitable tax treatment of two similarly situated taxpayers.

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building for an apartment complex tax free. The cost of razing the office building and constructing an apartment complex may make the exchange less tax elastic than an exchange of an office building for an office building. To obtain her goal of owning an apartment complex, Beatrice may be more inclined to exchange property and pay the tax, instead of paying to raze the office building and construct an apartment complex. *See* Shaviro, *supra* note 27, at 34 ("[The significance-of-change principle] suggests that sales that are a necessary byproduct of broader changes in the taxpayer's life or business are likely to be relatively tax inelastic."). If the tax on the exchange would induce Beatrice to demolish the office building instead of exchanging, the tax would be inefficient. It would cause excess burden not only with respect to Beatrice, but it would also cause excess burden by raising the price of the office building, which another taxpayer would acquire, but for the increase in price caused by the tax on the exchange. *See* ROSEN & GAYER, *supra* note 95, at 337–38 (demonstrating how a tax on commodity creates an excess burden).

136. *See* I.R.C. § 280B. Because Aladdin would have to add the cost to raze the building to the basis of the property, he would not recognize gain or loss on the transaction.

137. Allowing exchangers to exchange improved real property for unimproved real property tax-free and allowing them to exchange improved real property for other types of improved real property promotes efficiency. For example, if Beatrice owned unimproved land but wished to own a factory, she could either improve the land she owns or sell it and acquire an existing factory. If another person could use her land, constructing a factory on the land may not bring the land its highest and best use. Furthermore, the current owner of the factory that Beatrice would acquire may wish to dispose of the factory to trade up to a larger facility that is more suited for the factory owner's purposes. The factory owner could accomplish that by acquiring Beatrice's unimproved land and constructing a more suitable factory on the land. If a tax on the disposition of the factory would induce the owner to raze the existing factory and build a new one instead of exchanging the property, then the tax would be inefficient. It would raise no additional revenue but would affect Beatrice's actions. *See* ROSEN & GAYER, *supra* note 95, at 331 (demonstrating that a tax raising zero revenue makes a purchaser worse off).

138. *See* Treas. Reg. § 1.1031(a)-(1)(b) to -(1)(c) (as amended in 1991) (providing that improved city property is like kind to unimproved farm land).

Section 1031 supporters must admit that equity does not, however, support a more expansive interpretation of the section 1031 definition of like-kind property. This is not surprising because the members of a smaller group will likely have more in common than the members of a larger group.[139] As the definition of like-kind real property expands, some of the property that comes with the definition will be less like other property that comes within the definition. Equity would not support the tax-free exchange of many properties that would come within a broader definition of like-kind real property. For example, assume that Aladdin wishes to convert his fee simple interest in Property *A* into a mineral estate.[140] To do that, Aladdin would have to dispose of all interests in Property *A* other than the mineral estate. The disposition of such interests in the property would be a taxable event.[141] Because Aladdin's conversion of his fee interest in Property *A* into a mineral estate would be taxable, equity does not support Beatrice's tax-free exchange of her fee simple interest in Property *B* for a mineral estate. Thus, to the extent that section 1031 allows the tax-free exchange of a fee simple interest in real property for a mineral estate, section 1031 violates equity.[142]

The broad interpretation of the definition of like-kind real property appears to extend section 1031 to another group of exchangers who are not like holders of property. Consider the tax consequence to Aladdin if he were to convert his fee simple interest in Property *A* into a concurrent ownership interest, such as a tenancy-in-common interest. To do that, Aladdin would have to sell or otherwise transfer a tenancy-in-common interest to another person.[143] The transfer of such interest would be a

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139. *See* J.R. Lucas, *Vive la Difference*, 53 PHIL. 363, 364 (1978) ("Peer-groups operate at a somewhat low emotional temperature, and the larger the group the lower the temperature usually is. This is because the members are not alike in all respects, and, in general, if there are to be many members, then the things they have in common must be fewer.").

140. *See* Borden, *supra* note 60, at 28 (defining the mineral estate).

141. *See* I.R.C. § 61(a)(3) (requiring inclusion of gains derived from dealings in property in gross income); *id.* § 1001(a) (providing that taxpayers must recognize gain or loss on the sale or other disposition of property). This example assumes Aladdin disposes of Property *A* in a taxable transaction for consideration. Aladdin would have no gain or deductible loss if he were to transfer the fee interest as a gift. Aladdin would receive no consideration if the transfer were a gift transfer, so he would have no gain, and section 165 would not allow him to deduct the basis he had in the transferred property. *Id.* § 165(a)–(c).

142. The definition of like-kind real property appears to be broad enough to support such a tax-free exchange. *See* Comm'r v. Crichton, 122 F.2d 181, 182 (5th Cir. 1941) (holding that a mineral interest, which was real property under state law, was like kind to undivided interests in a city lot). Nonetheless, the definition is not broad enough to include all interests in real property. *See, e.g.*, Wiechens v. United States, 228 F. Supp. 2d 1080, 1085 (D. Ariz. 2002) (holding that water rights, which were real property under state law, were not like kind to land); *see also* Borden, *supra* note 60, at 20–32 (discussing the like-kind standard for partial real estate interests).

143. *See* 7 RICHARD R. POWELL, POWELL ON REAL PROPERTY § 50.02[3][a] (Michael Allan Wolf ed., rev. vol. 2007) (noting that a tenancy-in-common may be created by conveyance).

taxable event[144] but for section 1031 or some other nonrecognition provision.[145] Because Aladdin cannot convert Property *A* into a concurrent-ownership interest tax-free, equity would prohibit Beatrice from exchanging Property *B* tax-free for a concurrent interest in other property. Nonetheless, section 1031 currently allows the exchange of a fee simple interest for a concurrent interest.[146] Although generally supporting the concept of section 1031, equity does not support such a broad interpretation of the definition of like-kind property.

Section 1031 treats leases of thirty years or more like a fee interest in real property.[147] Aladdin could convert his fee interest in Property *A* to a lease of thirty years or more by transferring a reversionary interest (i.e., the right to take possession of the property after the lease expires)[148] in the property to a third party. If that reversionary interest had no value, Aladdin would recognize no income on the transfer of the interest. By treating a leasehold of thirty or more years as the equivalent of a fee, section 1031 assumes the reversionary interest has no value.[149] Under that assumption, Aladdin can convert his fee interest in Property *A* to a lease of thirty or more years tax free, and equity would suggest that Beatrice should also be able to exchange Property *B* for a leasehold of thirty years or more tax free.[150]

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144. *See supra* note 141.

145. *See* I.R.C. § 1001(c).

146. *See* Rev. Rul. 73-476, 1973-2 C.B. 300 (ruling that an exchange of undivided tenancy-in-common interests for a fee simple interest qualified for section 1031 nonrecognition); I.R.S. Priv. Ltr. Rul. 200019019 (May 12, 2000) (ruling that an exchange of fee simple interests in property for undivided tenancy-in-common interests qualified for section 1031 nonrecognition).

147. *See* Treas. Reg. § 1.1031(a)-1(c)(2) (as amended in 1991); *see also* R. & J. Furniture Co. v. Comm'r, 20 T.C. 857, 865 (1953) ("Leaseholds for such an extended period of time have been administratively classified in [the section 1031 regulations] as property of a like kind with and the equivalent of a fee in real estate within the purview of [section 1031]."), *rev'd on other grounds*, 221 F.2d 795 (6th Cir. 1955); Borden, *supra* note 60, at 21 (recognizing that the basis of the IRS's and court's interpretation of the thirty-year rule related to leases is unknown).

148. BLACK'S LAW DICTIONARY 1345 (8th ed. 2004).

149. *See R. & J. Furniture Co.*, 20 T.C. at 865 ("Thus, it appears that petitioner acquired a leasehold interest in the property, the bare fee of which was retained, and, which, if not the equivalent of a fee, constituted substantially all of the partnership's interest therein.").

150. In contrast to transferring a reversionary interest, a property owner recognizes ordinary income when entering into a lease as a lessor. *See* Treas. Reg. § 1.61-8(a) (as amended in 2004) (requiring a lessor to include rent in income). *But see* Treas. Reg. § 1.61-8(b) (as amended in 2004) (providing a limited exception to the general rule of income recognition on the receipt of prepaid rent in the case of payments that qualify as section 467 loans). Therefore, Aladdin could not enter into a lease tax free. Section 1031 preserves equity in this situation by disallowing a property owner to enter into a lease as a lessor tax free. *See* Pembroke v. Comm'r, 23 B.T.A. 1176, 1177 (1931) (holding that a lessor does not satisfy the section 1031 exchange requirement by entering into a lease); Butler v. Comm'r, 19 B.T.A. 718, 730–31 (1930) (holding that entering into a lease as a lessor is not a transfer of property); Borden, *supra* note 60, at 34–36 (discussing the different tax

Equity also supports exchanges of personal property. Consider the owner of a truck. The truck owner could do a significant amount of work on the truck tax free. For example, the owner could replace many of the truck's important components, such as its engine and transmission.[151] After such an upgrade, the truck would be like new in some respects. Because the upgrade is tax free, equity would indicate that the owner should be able to exchange the truck for a different truck tax free. However, because the owner could not upgrade the truck into a grader, equity suggests that the owner should not be able to exchange the truck for a grader tax free.

Section 1031 supporters are less skeptical of the harm to vertical equity than are the section's critics. In the current exchange environment, property owners can structure exchanges relatively inexpensively with the assistance of a qualified intermediary.[152] All owners of qualified property may use section 1031, and apparently a significant number of taxpayers could exchange property under section 1031.[153] As stated above, the median value of an exchange facilitated by IPX1031 over an eighteen-month period was $220,000.[154] If that represents the life's saving for an exchanger,[155] allowing gain deferral on such an exchange does not appear to inappropriately narrow the tax base for such taxpayers.[156] Instead, this

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treatment under section 1031 afforded to taxpayers who enter into leases as lessors and those who enter into leases as lessees).

151. The owner would be able to deduct the costs of routine maintenance. *See* Treas. Reg. § 1.162-4 (as amended in 1960). The owner would have to capitalize the cost of the new engine and transmission, and the installation costs. *See* Treas. Reg. § 1.263(a)-2(a) (as amended in 1987).

152. *See* IPX1031 Letter, *supra* note 13 (providing that typical qualified-intermediary fees range from $400 to $1,500 plus deposit-based revenue generated from exchange funds).

153. A qualified intermediary recently shared with the Author an anecdote that describes the availability of section 1031 to a broad cross-section of taxpayers. The professional qualified intermediary said that the smallest exchange that he ever facilitated was in the $15,000 range. According to the qualified intermediary, the property owner was aware of the transaction costs of doing the exchange and understood tax deferral. Because the tax benefits that section 1031 provides outweighed such costs, however, the property owner proceeded with the exchange. Taxpayers with subsistence income generally would not hold property that qualifies for section 1031 exchange, but such taxpayers generally should not pay tax because of available deductions and credits.

154. *See supra* text accompanying note 21.

155. The information in the IPX1031 Letter does not identify the percent of the exchangers' net worth that the exchange balances represent. The IPX1031 Letter also does not disclose whether the exchanges represent single transactions by many exchangers or many transactions by a few exchangers. Anecdotal evidence from the Author's experience advising exchangers and discussions the Author has had with qualified intermediaries indicate, however, that exchange balances often represent a significant portion of the exchangers' net worth.

156. To the extent that section 1031 provides a higher proportioned tax break to wealthy taxpayers than to less wealthy taxpayers, it violates vertical equity. In that respect, section 1031 would favor the super wealthy, much as other tax provisions do. *See generally* Martin J. McMahon, Jr., *The Matthew Effect and Federal Taxation*, 45 B.C. L. REV. 993 (2004) (discussing how tax law has provided disproportionately large tax breaks for the super wealthy).

gain deferral allows individuals in an asset-intensive industry, such as real estate rental, to save money tax free, much like wage earners who contribute to retirement plans are able to save money tax free.[157]

This discussion reveals the like-kind exchange equity conundrum and presents the challenge. Some commentators throw in the towel regarding the equity issue, claiming that equity adds nothing to the analysis because equity can support the respective contradictory positions of the section 1031 critics and supporters.[158] The remainder of this Article considers the

157. *See* I.R.C. §§ 401, 402, 408, 408A, 501 (West 2008) (exempting from taxation certain retirement plans). The median balance of exchange proceeds received is similar to the 2001 median household wealth for all Americans age forty-five to fifty-four with a retirement account. *See* Craig Copeland, *Retirement Accounts and Wealth, 2001*, EMP. BENEFIT RES. INST. NOTES, May 2004, at 5, 12, *available at* http://www.ebri.org/pdf/notespdf/0504notes.pdf. Based on the information about median household wealth, if the $220,000 median exchange balance represents the wealth of an exchanger, the median wealth of an exchanger would be similar to the median household wealth of Americans older than forty-five with retirement accounts. The information in the IPX1031 Letter is not comprehensive. For example, the letter does not reveal the age of the exchangers or the wealth of the exchangers. The deficiency of information about exchangers makes any comparison speculative, but the information reveals the distinct possibility that exchangers, on average, are similar to the cross-section of taxpayers who save for retirement. The information also indicates that this issue merits additional empirical research.

Median Household Wealth For All Americans Age 21 or Older With or Without a Retirement Account, September–December 2001

	All		With Retirement Account		Without Retirement Account	
	Number (millions)	Median Wealth	Number (millions)	Median Wealth	Number (millions)	Median Wealth
All	200.7	$73,708	66.3	$171,225	134.4	$41,117
Age						
21-24	14.9	13,550	1.6	26,400	13.3	12,108
25-34	39.1	22,005	12.0	54,682	27.1	11,208
35-44	45.3	63,508	17.1	135,426	28.2	29,050
45-54	40.9	104,921	17.3	207,806	23.5	53,562
55-64	26.2	146,110	10.4	306,475	15.8	74,927
65-69	9.8	148,550	3.1	357,900	6.7	88,462
70 or older	24.6	136,708	4.8	323,141	19.8	105,181

Id.

158. *See* Brown, *supra* note 25, at 716 ("Providing nonrecognition treatment to the like kind exchanger treats the exchanger like the continued holder, but creates horizontal inequity with the seller. Similarly, imposing current tax on the exchanger produces equity with the seller but not with

role that equity should play in analyzing section 1031 and provides a solution to the equity conundrum.

V. CONUNDRUM'S SOLUTION

Based on the arguments raised by section 1031 critics and supporters, the like-kind exchange equity conundrum asks the following: Should exchangers of like-kind property be taxed (1) like property holders or (2) like sellers and exchangers of non-like-kind property?[159] The process of answering that question begins by identifying the appropriate criteria to use as a point of comparison. This Article accepts accretion (a broad definition of income that includes consumption and increases in wealth) as the appropriate criterion.[160] Using accretion as the criterion, equity requires that property owners be taxed on appreciation of property. In an ideal setting, holders would be taxed on appreciation, and exchanges would become irrelevant in determining whether to tax.[161]

The analysis in this Part demonstrates that a tax on appreciation creates inequity when property is illiquid or difficult to value. Equity suggests that owners of illiquid and difficult-to-value property should not pay tax on the appreciation of the property. Once equity exempts some property holders from the general accretion rule, the analysis of exchangers must occur in a second-best setting, in which some property holders are exempt from taxation on accretion.[162] Treating exchangers of like-kind property differently from property holders would create excess burden and discourage property owners from entering into like-kind exchanges.[163]

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the holder."); David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1646 (1999) ("Horizontal equity, another traditional tax criterion, is even less helpful for line drawing than the Haig-Simons definition.").

159. One could argue, in the alternative, to retain the concept of tax-free like-kind exchanges but to modify the current structure to narrow the definition of like-kind real property and to eliminate the prohibition of receiving exchange proceeds. As discussed above, equity proponents do not claim that equity supports a broad definition of like-kind real property. *See supra* text accompanying notes 139–46. Equity does, however, support the prohibition of receipt of exchange proceeds. *See supra* text accompanying notes 128–31.

160. This Article accepts accretion as the criterion because section 1031 critics use it as the criterion in their analyses, and the equity question would become moot with respect to section 1031 if consumption were the criterion. *See infra* text accompanying note 181.

161. If holders of property are taxed as the property appreciates, the holders would have little if any gain to realize on the exchange of property. For example, if Beatrice purchased property for $50,000 and was taxed on $50,000 of appreciation, she would have no gain if she later exchanged the property for other property worth $100,000.

162. Commentators realize that a first-best setting generally is not possible. *See, e.g.*, MUSGRAVE & MUSGRAVE, *supra* note 70, at 228 ("Since the economy itself is complex and the tax law must be tailored thereto, no single concept of tax base can be implemented to perfection.").

163. The section 1031 efficiency question thus considers whether tax law may discourage the economic activity of exchanging. It does not concern itself with whether exchanging is preferable

Thus, a comparative equity rule—once the system adopts the realization requirement and exempts holders from gain realization, the system should exempt similarly situated exchangers from recognition—requires that exchangers of like-kind property be treated like holders.

A. *Criteria for Equity Analysis*

Every person is like others under certain criteria and unlike others under other criteria.[164] To apply equity effectively, one must make substantive judgments about what criteria are important.[165] Comparisons without criteria based on legitimate standards may result in absurd applications of the law. For example, the central government of a planned economy could use geographic location as the criterion to determine who is alike.[166] Based on that criterion, the central government could determine

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to selling or whether exchanging is preferable to holding. It merely asks whether taxing exchanges of like-kind property might discourage a transaction (an exchange) that would otherwise occur.

164. *See* Lucas, *supra* note 139, at 363–64 ("Men are all alike . . . Men are all different. We are all alike in being featherless bipeds, language-using animals, sentient beings, centres of consciousness, and, granted certain conditions of age and health, rational agents. Each of us is different in spatio-temporal location, and, identical twins apart, in his genetic inheritance and the detailed biochemistry of his body; and, at a more conceptual level, in as much as each has a mind of his own, and can make up his mind for himself, and can make it up differently from anyone else."). Tax law complicates the simple comparison of humans because tax law's definition of person is broader than individuals. *See* I.R.C. § 7701(a)(1) (2000) ("The term 'person' shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation."). Clearly the differences between humans and inanimate legal fictions such as trusts, estates, partnerships, and corporations are significant. The legal fictions do not have emotions and are incapable of acting on their own. The similarities are less obvious, except for the legal rights granted to such fictions. The legal fictions, much like their human counterparts, may hold property, have access to legal systems, and otherwise engage in commercial transactions. Thus, comparisons exist even between humans and inanimate legal fictions that come within the federal tax definition of person.

165. *See* Kent Greenawalt, *How Empty Is the Idea of Equality?*, 83 COLUM. L. REV. 1167, 1178 (1983) ("In order to decide what persons are relevantly equal or unequal, substantive judgments have to be made about what characteristics count.").

166. This hypothetical comes from a former Chinese regulation. During the planning-economy period, the regulation provided that

> there be no heating at all south of the Yangtze River; between the Yangtze and Yellow Rivers there was only heating in offices and none at homes; north of the Yellow River there was heating both at offices and homes. . . . Weihai was located in the area between the Yangtze River and Yellow River, so Weihai only had heating in the office and none in the homes.

U.N. ECON. & SOC. COMM'N FOR ASIA & THE PAC., CITIES AND SUSTAINABLE DEVELOPMENT: LESSONS AND EXPERIENCES FROM ASIA AND THE PACIFIC, at 183, U.N. DOC. ST/ESCAP/2290, U.N. Sales No. 04.II.F.13 (2003), *available at* http://www.unescap.org/esd/publications/Cities_Development.pdf.

that everyone north of a river is like each other but unlike all those south of the river, and everyone south of the river is like each other but unlike all those north of the river. Having established the groups of like individuals, the government may promulgate a rule that applies to the group north of the river and a different rule that applies to the group south of the river. Thus, without violating the basic Aristotelian concept of equity, the government could permit all people north of the river to heat their homes and prohibit those people south of the river from heating their homes. Because such a rule treats likes (everyone north of the river) alike (allows them to heat their homes) and treats unalikes (everyone south of the river) unalike (prohibits them from heating their homes), the rule arguably complies with the basic Aristotelian concept of equity. Nonetheless, the result is absurd.

The result is absurd because it establishes a criterion that only marginally relates to the application of the rule. Because the rule addresses comfort, a more appropriate criterion would have been comfort. People on both sides of the river, especially those closest to the river, may be equally cold, and thus uncomfortable, without heat.[167] The rule would have been less absurd if it had provided that people whose homes are in a location where temperatures drop below a certain level on a particular day may heat their homes, while prohibiting all others from heating their homes.[168] Although comfort may be a more appropriate criterion for determining which homeowners may use heating systems, the basic Aristotelian concept of equity does not indicate the proper criteria to use. The basic Aristotelian concept of equity does not provide a palatable result when the criteria of comparison are absurd.[169] Thus, some method of determining the

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167. Indeed, the Chinese government abandoned this regulation when China entered the market economy. *Id.* People did not like staying in cold homes and began to heat their homes to enjoy comfortable temperatures. *Id.*

168. Although this rule is less absurd than the rule based on geographic location, it is as tautological as the other rule. One could apply either rule without comparing parties to each other.

169. Treating likes alike may also raise nonsensical, even humorous, rules, such as that recalled by Abraham Lincoln from his experiences in the militia as a youth:

> We remember one of these parades ourselves here, at the head of which, on horse-back, figured our old friend Gordon Adams, with a pine wood sword, about nine feet long, and a paste-board cocked hat, from front to rear about the length of an ox yoke, and very much the shape of one turned bottom upwards; and with spurs having rowels as large as the bottom of a teacup, and shanks a foot and a half long. That was the last militia muster here. Among the rules and regulations, no man is to wear more than five pounds of cod-fish for epaulets, or more than thirty yards of bologna sausages for a sash; and *no two men are to dress alike, and if any two should dress alike the one that dresses most alike is to be fined,* (I forget how much). Flags they had too, with devices and mottoes, one of which latter is, "We'll fight till we run, and we'll run till we die."

H. RICHARD UVILLER & WILLIAM G. MERKEL, THE MILITIA AND THE RIGHT TO ARMS, OR, HOW THE criteria is needed.

Even if the criteria do not produce an absurd result, two sets of criteria may appear equally justified. Section 1031's critics and supporters do not agree on the appropriate criteria for analyzing the equity of section 1031.[170] Unfortunately, the basic Aristotelian concept of equity does not identify the appropriate criteria. Commentators have recognized this dilemma in the section 1031 context.[171] Under the current tax system, regardless of the changes to section 1031, inequity could continue, depending upon the criteria selected for comparison.

The outcome of an equity analysis often depends upon the tax base used as a basis of comparison.[172] The two general tax bases are accretion and consumption.[173] The accretion tax base is broad, including all of a taxpayer's consumption and all increases in value of property held by the taxpayer.[174] The consumption tax base is narrower, including only

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SECOND AMENDMENT FELL SILENT 123–24 (2002) (quoting Abraham Lincoln, Speech to the Springfield Scott Club (Aug. 14, 1852), *in* THE COLLECTED WORKS OF ABRAHAM LINCOLN 135, 149–50 (Roy P. Baller ed., 1953)) (emphasis added).

170. Section 1031 critics rely upon criteria that indicate exchangers are like sellers (i.e., transfer of property), while section 1031 supporters rely upon criteria that indicate exchangers are like holders (i.e., continued investment). *See supra* Part IV.

171. *See, e.g.*, Brown, *supra* note 25, at 717 (suggesting that because the tax system does not tax accretion, an equity analysis does not provide guidance regarding section 1031). Professor Brown recognized that with accretion income as the comparative basis, section 1031 violates horizontal equity with respect to a taxpayer who sells property for cash or non-like-kind property. *Id.* at 716–17. He recognizes that section 1031 satisfies horizontal equity with respect to a taxpayer who continues an investment in property. *Id.* at 716. Similarly, Professor Brown argues that perceptional equity offers little help in analyzing section 1031. *See id.* at 717–18. He later uses equity to compare involuntary conversions to like-kind exchanges. *See, e.g.*, *id.* at 726–27, 734, 736; *see also* Weisbach, *supra* note 158, at 1646–47 ("If *A*, *B*, and *C* are all 'equals,' but *A* is taxed differently from *C*, horizontal equity cannot determine how to tax *B*. According to the horizontal equity norm, *B* must be taxed like both *A* and *C*. If *B* is taxed like *A*, horizontal equity is violated because *B* also must be taxed like *C* and vice versa. No matter where the line is drawn, it will violate horizontal equity.").

172. *See, e.g.*, MUSGRAVE & MUSGRAVE, *supra* note 70, at 223–28 (analyzing income, consumption, wage, and wealth as tax bases); Sneed, *supra* note 102, at 577–78 (identifying consumption and accretion as meanings of income).

173. Accretion, or income as referred to by some commentators, includes "money income (such as wages, salaries, interest, or dividends), imputed income (such as imputed rent from owner-occupied housing), and appreciation (whether realized or not) in the value of assets." MUSGRAVE & MUSGRAVE, *supra* note 70, at 224. Consumption differs from accretion by not including amounts that are saved. *Id.* As Professors Musgrave and Musgrave demonstrate, using wealth as the tax base may also serve as an appropriate reference point in determining horizontal equity. *See id.* Because the idea of using wealth as a tax base does not receive much attention in tax literature, this Article does not discuss this idea.

174. *See* SIMONS, *supra* note 94, at 50 ("Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question."). Several arguments advance the broad definition of income. *See, e.g.*, *id.* at 105–06 (suggesting that a

consumption.[175] Like the positions scholars take in the debate over vertical equity, the appropriate tax base is "a matter of social taste and political debate."[176] Scholars have debated the appropriateness of the different tax bases for decades, and the debate will undoubtedly continue indefinitely.[177]

Section 1031 provides an excellent example of the importance of the tax base in a horizontal-equity analysis. If an analyst uses an accretion tax base, an exchanger of like-kind property will have as much income as the seller of property.[178] For example, if Beatrice purchases Property *B* for $50,000 and exchanges it for like-kind Property *D* worth $100,000, Beatrice will have $50,000 of accretion income. If Drew purchases Property *D* for $50,000 and later sells it for $100,000, Drew will also have $50,000 of accretion income. Because Beatrice and Drew both have $50,000 of accretion income, horizontal equity suggests that they should both pay the same amount of tax.

If, on the other hand, an analyst uses consumption as the appropriate tax base, horizontal equity produces a different result. For example, Beatrice would have no consumption income when she exchanges Property *B* for Property *D*.[179] Therefore, she would have no income and should not pay tax on that transaction. Similarly Drew, who sells Property *D* but retains the proceeds (as opposed to spending them in consumption),

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broader concept of income helps evaluate existing and proposed income tax approaches).

175. *See* MUSGRAVE & MUSGRAVE, *supra* note 70, at 224.

176. *See* Musgrave, *supra* note 95, at 113.

177. *See, e.g.*, Andrews, *supra* note 115 (suggesting that a consumption model offers better solutions for personal tax than the existing accretions model); Alvin C. Warren, Jr., *Fairness and a Consumption-Type or Cash Flow Personal Income Tax*, 88 HARV. L. REV. 931 (1975) (arguing against Professor Andrews's assertion that a consumption-based tax is fairer than an accretion-based tax); William D. Andrews, *Fairness and the Personal Income Tax: A Reply to Professor Warren*, 88 HARV. L. REV. 947 (1975) (rebutting Professor Warren's arguments against the consumption model); Alvin Warren, *Would a Consumption Tax Be Fairer than an Income Tax?*, 89 YALE L.J. 1081 (1980) (critiquing arguments in favor of the consumption-based model); *see also* SIMONS, *supra* note 94, at 30–31 ("An ideal income tax should involve a minimum of obvious inequity; and the writer believes that, in general, the broadest and most objective income concept provides the base for the most nearly equitable levies."). For a recent argument in favor of a consumption base, see Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax over an Ideal Income Tax*, 58 STAN. L. REV. 1413 (2006).

178. This assumes that property owners do not realize or recognize income before the transfers. If accretion income required annual computation and reporting of appreciation, the transfers of property prior to such computation and reporting should trigger gain realization and recognition.

179. Some commentators perceptively observe that at the time of the Sixteenth Amendment's ratification, Congress did not contemplate using consumption as a tax base for the tax system. *See* ERIK M. JENSEN, THE TAXING POWER: A REFERENCE GUIDE TO THE UNITED STATES CONSTITUTION 62–64 (2005). Nonetheless, other commentators argue that the definition of income should be consumption. *See* Bankman & Weisbach, *supra* note 177, at 1414. That debate exceeds the scope of this Article; here the term "income" is used broadly to illustrate the point without accepting the view that a consumption definition of income is appropriate.

would have no consumption income.[180] Because Drew has no consumption income, he should be treated the same as Beatrice, who has no consumption income, and he should not pay any tax on the transaction. Thus, the choice of tax base is very important in the equity analysis of section 1031. Because the consumption tax would not tax exchanges and sales, thus eliminating the equity conundrum, this Article accepts accretion as the appropriate tax base for the sake of analysis.[181]

As long as an accretion tax system includes a realization requirement, narrowing, repealing, or expanding section 1031 will not eliminate inequity; rather, an accretion system will merely shift the equity split. For example, assume that Aladdin owns Property *A*, which he purchased for \$50,000. Beatrice owns Property *B*, which she purchased for \$50,000. Cloy owns Property *C*, which she purchased for \$50,000. Drew owns Property *D*, which he purchased for \$50,000. At a time when all the property is worth \$100,000 (assume all property is liquid and easily valued), Beatrice transfers Property *B* for Property *E* in an exchange that qualifies for section 1031 nonrecognition. Cloy exchanges Property *C* for Property *F* in a transaction that does not qualify for section 1031 nonrecognition. Finally, Drew sells Property *D* for \$100,000. Table 1 illustrates these exchanges, and the economic and tax implications associated with the exchanges.

Table 1: Equity Split—Current Law

	Aladdin	**Beatrice**	**Cloy**	**Drew**
Situation	Holds Prop *A*	Exchanges Prop *B* for Prop *E*	Exchanges Prop *C* for Prop *F*	Sells Prop *D* for \$100,000
Accretion Tax Base	\$50,000	\$50,000	\$50,000	\$50,000
Gross Income	\$0	\$0	\$50,000	\$50,000
Tax Liability	\$0	\$0	\$15,000	\$15,000

Equity Split

180. Alternatively, if the consumption tax were based on cash flow, Beatrice and Drew would have income when they received the sale proceeds, and they would take a deduction only when they reinvested the proceeds. *See* Andrews, *supra* note 115, at 1152. Presumably, an investment in cash savings would qualify for a deduction. *See id.* at 1161–62 (suggesting that cash savings should be deductible under a consumption tax).

181. *See supra* note 160 and accompanying text.

To apply equity in the tax context, one must choose a tax theory. Using the benefits theory, the abilities theory, or the utility theory will affect the outcome of an equity analysis. The benefits theory focuses on the public services that taxpayers receive.[182] Under the benefits theory, equity requires that taxpayers who receive similar amounts of public goods pay a similar amount of tax.[183] The abilities theory allocates the tax burden according to taxpayers' ability to pay.[184] Under the abilities theory, equity requires taxpayers with similar abilities to pay a similar tax.[185] Under the utility theory, equity provides that parties who are equal before tax should be equal after tax.[186] Each theory brings application complexities, and theorists do not agree on the appropriate theory to apply.

Examples demonstrate how the different theories may affect the equity analysis. Beatrice exchanges Property *B* for Property *E*, which is worth $100,000. Drew earns $50,000 on the sale of Property *D*. To apply the benefits theory, one must know the amount of public services that Beatrice and Drew receive from the government. The amount of tax each pays should reflect the benefits received.[187] They both receive police protection and the benefits of national defense, which allow Beatrice to own her property and Drew to sell his property. If Beatrice were completely self-sufficient on her property, she might argue that Drew benefits from the infrastructure, which provides no benefit to Beatrice. If Drew received more public goods than Beatrice, equity would require that he pay more tax. Significant information is needed to accurately assess the benefits each party receives.

Equity incorporates the abilities theory by considering each party's ability to pay tax and allocating the tax burden based upon that ability. Assuming Property *E* is liquid, Beatrice would have $100,000 to use to pay taxes and Drew would have $50,000. Under the abilities theory, at first blush it appears that Beatrice should pay more tax than Drew, but an abilities comparison should also consider the cost each party incurs to satisfy life's necessities. If Beatrice has more children than Drew, then, *ceteris paribus*, the abilities theory would suggest that Beatrice would

182. *See* MUSGRAVE & MUSGRAVE, *supra* note 70, at 220.

183. *See id.* at 219.

184. *See* ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSE OF THE WEALTH OF NATIONS 777 (Edwin Cannan ed., Modern Library 1937) (1776) ("The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities . . . .").

185. *See* MUSGRAVE & MUSGRAVE, *supra* note 70, at 223.

186. This derives from the utility definition of horizontal equity: "[I]f two individuals would have the same utility level in the absence of taxation, they should also have the same utility level if there is a tax." Martin Feldstein, *On the Theory of Tax Reform*, 6 J. PUB. ECON. 77, 94 (1976).

187. *See* MUSGRAVE & MUSGRAVE, *supra* note 70, at 220 (recognizing that people's preferences make determining benefits difficult).

need more resources to satisfy the necessities of her life and her children's lives than Drew would need to satisfy the necessities of his life. The various factors that go into determining one's ability to pay make the abilities theory difficult to assess and apply perfectly.[188]

The information required to assess utility makes it similarly difficult to apply in an equity analysis. For example, Beatrice may value leisure more than she values property, whereas Drew may value money more than leisure. In that case, a dollar of tax paid by Drew, which reduces his store of money, would reduce his well-being more than a dollar reduction of Beatrice's property would reduce her well-being (assuming the tax did not affect Beatrice's leisure). Without perfect information, any analysis using any of the theories must adopt assumptions that inform the application of each theory. The following analysis assumes that each person receives benefits from the government in proportion to income. Thus, the analysis in this Article does not consider the benefits theory. Instead, this Article adopts the abilities theory and the utilities theory.[189] To simplify the analysis, this Article assumes that each person's accretion reflects the person's ability to pay and that the value of assets reflects the holder's utility.[190]

Based on these assumptions, under an accretion tax system, each person has $50,000 of income, which would equal each person's ability to pay tax. Aladdin does not realize any income, however, under the realization requirement, and, under section 1031, Beatrice does not recognize income. Cloy and Drew, however, have recognizable income. Assuming a single tax rate and that the government needs $30,000 of tax revenue, Cloy and Drew will each pay $15,000 of tax. Each person has $50,000 of accretion, so each should pay the same amount of tax. The law provides, however, that only two of the four individuals pay tax. By not taxing Aladdin and Beatrice, the law violates equity, or so section 1031

188. *See id.* at 223 ("Ideally, this measure would reflect the entire welfare which a person can derive from all the options available to him or her, including consumption (present and future), holding of wealth, and the enjoyment of leisure. Unfortunately, such a comprehensive measure is not practicable.").

189. *See* Harvey S. Rosen, *An Approach to the Study of Income, Utility, and Horizontal Equity*, 92 Q.J. ECON. 307, 307 (1978).

> Customarily, 'equal positions' are defined in terms of some observable index of ability to pay such as income, expenditure, or wealth. . . .
>
> In order to put a discussion of horizontal equity on the same plane as the optimal taxation literature, it is useful to define it in terms of utility rather than ability to pay.

Id.

190. *See* MUSGRAVE & MUSGRAVE, *supra* note 70, at 223 ("[S]ome second-best but observable measures must do.").

critics say.[191]

Section 1031 critics argue, among other things, that section 1031 violates equity by treating exchangers of like-kind property differently from exchangers of non-like-kind property.[192] Repealing section 1031 would eliminate the perceived inequity between exchangers of like-kind property and non-like-kind property. Repeal of section 1031 would not, however, solve the overall problem of inequity. For the sake of analysis, assume that the repeal of section 1031 would not affect Beatrice's behavior.[193] If Congress repealed section 1031, Beatrice would recognize \$50,000 of gain on the exchange of Property *B* for Property *E*.[194] If the revenue needs remained constant, Beatrice, Cloy, and Drew would bear the \$30,000 tax burden equally—each would pay \$10,000 of tax. Aladdin would pay no tax. Repealing section 1031 would therefore remove the equity split between Beatrice and Cloy but would not eliminate inequity. Instead, the repeal of section 1031 would merely shift the equity split to the left. In a system without section 1031, the equity split would be between Aladdin and Beatrice. Table 2 illustrates these exchanges, and the economic and tax implications associated with the exchanges if section 1031 were repealed.

Table 2: Equity Split—Section 1031 Repealed

	Aladdin	**Beatrice**	**Cloy**	**Drew**
Situation	Holds Prop *A*	Exchanges Prop *B* for Prop *E*	Exchanges Prop *C* for Prop *F*	Sells Prop *D* for \$100,000
Accretion Tax Base	\$50,000	\$50,000	\$50,000	\$50,000
Gross Income	\$0	\$50,000	\$50,000	\$50,000
Tax Liability	\$0	\$10,000	\$10,000	\$10,000

Equity Split

191. *See supra* Part IV.A. Although treating Beatrice and a hired service provider differently also violates horizontal equity under the stated criteria, the section 1031 critics focus on the different treatment of exchangers of non-like-kind property and of sellers of property.

192. *See supra* notes 109–11 and accompanying text.

193. The tax on the exchange would likely affect Beatrice's decision whether to exchange Property *B* for Property *E*. *See* Shaviro, *supra* note 27, at 34 (discussing the "significance-of-change" principle).

194. *See* I.R.C. § 1001(c) (2000) (requiring gain recognition generally).

Another way to eliminate the original equity split between Beatrice and Cloy is to expand the scope of section 1031 to include exchanges of property that are not like kind. This expansion would shift the equity split to the right. If section 1031 were expanded to include non-like-kind exchanges, tax law would treat Beatrice and Cloy similarly. That treatment would remove the Beatrice–Cloy equity split as effectively as repeal of section 1031 would remove it, but equity does not merely require the elimination of the Beatrice–Cloy equity split. Table 3 illustrates these exchanges, and the economic and tax implications associated with the exchanges under an expanded section 1031.

Table 3: Equity Split—Section 1031 Expanded

	Aladdin	**Beatrice**	**Cloy**	**Drew**
Situation	Holds Prop *A*	Exchanges Prop *B* for Prop *E*	Exchanges Prop *C* for Prop *F*	Sells Prop *D* for $100,000
Accretion Tax Base	$50,000	$50,000	$50,000	$50,000
Gross Income	$0	$0	$0	$50,000
Tax Liability	$0	$0	$0	$30,000

Equity Split

Expanding section 1031 moves the equity split that the section 1031 critics recognize, but the critics generally do not advocate expanding section 1031.[195] The lack of advocacy for shifting the equity split indicates that section 1031 critics may favor accretion taxation as much as they favor equity.[196] More importantly, the shift fails to eliminate inequity.

195. One criticism of section 1031 is that the exchange requirement is too complex and should be replaced with a rollover provision. *See* Brown, *supra* note 25, at 741–46. If section 1031 were a rollover provision (i.e., if it allowed exchangers to receive relinquished property proceeds and forgo structuring), more transactions would qualify for section 1031 nonrecognition. Such arguments are generally made under an efficiency or convenience analysis, which identifies the qualified intermediary as a needless element of exchanges. *See id.* at 744 ("[I]t seems easy to dismiss these rules as purposeless formalism and complexity . . . .").

196. *See, e.g.*, McMahon, Jr., *supra* note 37, at 478–79 (including the recommendation to repeal section 1031 in the part of the article entitled *Base Broadening*); Kornhauser, *supra* note 2, at 445 ("The realization requirement is only a practical consideration. The trend today is to find realization—and thus taxability—in more and more instances."). Although a broader tax base may

Expanding the scope of section 1031 shifts the equity split to the right. After the equity shift, tax law would treat Cloy and Drew differently. These examples demonstrate that uncertain criteria do not solve the like-kind exchange equity conundrum. The criteria that both the section 1031 critics and supporters use are too narrow.

As long as accretion is the criterion for measuring equity, the only way to eliminate inequity within the tax system is to tax all accretion. By repealing section 1031 and eliminating the realization requirement (i.e., by adopting accrual taxation), the tax system could achieve equity in this simple example. Table 4 illustrates the economic and tax implications of the exchanges if section 1031 were repealed and the realization requirement were eliminated.

Table 4: Result With Accrual Taxation

	Aladdin	**Beatrice**	**Cloy**	**Drew**
Situation	Holds Prop *A*	Exchanges Prop *B* for Prop *E*	Exchanges Prop *C* for Prop *F*	Sells Prop *D* for $100,000
Accretion Tax Base	$50,000	$50,000	$50,000	$50,000
Gross Income	$50,000	$50,000	$50,000	$50,000
Tax Liability	$7,500	$7,500	$7,500	$7,500

No Equity Split

Perhaps not surprisingly, taxing the accretion of each person eliminates the equity split, but using accretion also makes the equity analysis derivative.[197] For example, to determine the tax liability of Aladdin, one

be justified, the equity argument becomes tautological if the goal is a broader tax base. Instead of making an equity argument, proponents of accretion should merely argue for a tax on the accretion of all taxpayers whenever possible. As this Article demonstrates, however, taxing all accretion may violate equity. *See infra* Part V.C.

197. The seminal work on questioning equity's normative significance is Professor Westen's *The Empty Idea of Equality*. *See* Westen, *supra* note 75, at 537–42. Several fairly recent articles have argued that equality remains significant. *See, e.g.*, Simons, *supra* note 76, at 416–34 (demonstrating that equality as a comparative right (referred to as comparative equity in this Article) has significance); *see also* Karst, *supra* note 88, at 247–49 (arguing that the American concept of equality requires that we treat each other with respect and avoid stigmatizing any person or group of people); *infra* Part V.D (applying a comparative equity analysis to section 1031). Taking issue with Professor Westen's analysis, Professor Chemerinsky argues that equality is morally, analytically, and rhetorically necessary. Erwin Chemerinsky, *In Defense of Equality: A Reply to Professor Westen*, 81 MICH. L. REV. 575, 575–76 (1983) (addressing the claims made by

need not compare Aladdin to any of the other parties. One could simply consider the amount of Aladdin's accretion and determine the tax he owes. Comparing Beatrice to Aladdin to determine Beatrice's tax would be derivative, as Beatrice's tax would depend upon her accretion, not the tax Aladdin paid. Such an analysis presents a significant problem because it becomes tautological.[198]

B. *Beyond the Equity Tautology*

Those questioning equity's significance claim that equity is a mere tautology.[199] The key to applying the Aristotelian concept of equity is determining who is alike. "To say that people are morally alike is therefore to articulate a moral standard of treatment—a standard or rule specifying certain treatment for certain people—by reference to which they are, and thus are to be treated, alike."[200] Once the standard of treatment is prescribed for certain people, that treatment should apply to all such people, not because such people are alike, but because the standard applies to such people.[201] Thus, if a rule specifies the class to which it applies, one can determine the applicability of the rule by reference to the rule. In such a situation, equity adds nothing to the analysis of the rule's applicability and may lead to the wrong result if criteria become confused. The above example demonstrates that merely comparing likes to likes is useless in an accretion tax system because the accretion rule would determine income. Aristotelian equity ceases to be tautological in the section 1031 context if the criteria are imperfect or if the application of the law based on the criteria produces an outcome that is inequitable. In such situations, equity reveals that the criteria may not produce the correct result.

A pure accretion tax system produces equitable results only if property is liquid and easily valued. If property is illiquid or not easily valued, the accretion tax base is less desirable. First, the inability to value property makes the application of a tax on accretion random. In such situations,

Professor Westen in *The Empty Idea of Equality*). According to Professor Chemerinsky, "the concept of equality compels us to care about the way we treat people in reference to each other" and is therefore morally necessary. *Id.* at 587. Equality is analytically necessary because it "provides an analytical counterweight to the prejudices of dominant groups, thereby serving a critical political function no other concept can perform as well." *Id.* at 590. Finally, because everyone can rally around the principle of equality to protect more particular principles and rights, it is rhetorically necessary. *Id.* at 591.

198. As a practical matter, taxing accretion would also have a broad impact on many other areas of the law. *See generally* Shaviro, *supra* note 27.

199. *See* Westen, *supra* note 75, at 547–48 ("Equality is an undeniable and unchangeable moral truth because it is a simple tautology.").

200. *Id.* at 545 (footnote omitted).

201. *See id.* at 552–53.

equity may warrant unequal treatment.[202] Second, taxing the appreciation of illiquid property threatens to produce inequitable results.

C. *Justified Unequal Treatment and the Realization Requirement*

Although the preference is to treat equals equally, unequal treatment is sometimes necessary.[203] Any unequal treatment requires justification.[204] The realization requirement provides an example of necessary unequal treatment in an accretion-type tax system. The realization requirement also upholds the basic Aristotelian concept of inequity because holders of property will not be taxed on accretion while sellers of property will be taxed. The realization requirement generally provides that a property holder does not have income before the sale or other disposition of property.[205] The most widely accepted justifications for the realization requirement are the inability to value the property and the property's lack of liquidity.[206] At the point of sale or other disposition, these difficulties diminish, and the tax system requires gain or loss realization.[207] Generally, taxpayers must recognize (i.e., report on their tax returns) realized gain or loss.[208] Section 1031, of course, provides an exception to the general rule requiring gain recognition. An exchanger of like-kind property realizes gain or loss on the exchange because an exchange is a disposition of property. But for section 1031, the exchange of property would be a realization event triggering gain recognition for the exchanger.

1. Valuation Difficulty

Comparing a taxpayer in an ideal, or first-best, setting to a taxpayer in a less-than-ideal, or second-best, setting helps explain the equity rationale

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202. *See* Greenawalt, *supra* note 165, at 1177. This is, of course, the basis for constitutional analysis that applies the various levels of scrutiny to determine the legality of laws that treat people differently. *See id.* at 1182.

203. *See id.* at 1173 ("The principle that unequals should be treated unequally does not deny that unequals can empirically be treated equally . . . .").

204. *See id.* at 1182.

205. *See* Shaviro, *supra* note 27, at 7.

206. *See id.* at 3 ("[E]veryone but a few brave souls assumes that a realization requirement is administratively necessary or at least politically inevitable . . . ."); David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111, 1113 (1986) ("Unfortunately, the accrual system has never attracted a large group of adherents because its twin problems of valuation (How can assets be valued every year?) and liquidity (How can taxpayers pay taxes if they do not sell their assets?) have never been solved." (footnote omitted)). Professor Shaviro refers to Professor Shakow as one of the brave souls who does not assume that realization is administratively necessary or politically inevitable. *See* Shaviro, *supra* note 27, at 3 n.13.

207. *See* I.R.C. § 1001(a) (2000) (providing the formula for computing gain or loss realized on the sale or other disposition of property); *id.* § 61(a)(3) (providing that gross income includes gain derived from dealings in property).

208. *See id.* § 1001(c).

for the realization requirement. The analysis compares Aladdin in the first-best setting (A_1) to Aladdin in the second-best setting (A_2). In the first-best setting, A_1 holds property that is easily valued and liquid. In the second-best setting, A_2 holds property that is illiquid and difficult to value. A_1 and A_2 each purchased their respective properties for \$50,000. A_1's property is now worth \$100,000. Appraisals indicate that A_2's property is worth between \$50,000 and \$150,000.

If accretion provided the tax base, taxing A_1 on his \$50,000 increase in value appears appropriate. Taxing A_2, however, raises difficulties because the range of valuations prevents a precise determination of A_2's tax base. If the actual value of A_2's property is \$50,000, then A_2 has no accretion and should pay no tax. If, on the other hand, the actual value of A_2's property is \$150,000, then A_2's income should include the \$100,000 increase in value. An imprecise estimate of A_2's property value would create an equity dilemma. Hohfeldian relationships help illuminate the equity dilemma and lead to the most desirable result.[209]

Tax law creates a Hohfeldian liability to pay tax on income and a Hohfeldian immunity from paying other direct taxes.[210] An accretion tax system imposes a liability on property owners to pay tax on increases in the value of property, but this system cannot violate the property owners' immunity from tax if the value does not increase. A perfect accretion tax system would correctly impose an absolute liability on A_1 to pay tax and should grant an absolute immunity to A_2 not to pay tax, except to the extent of actual increase in value. An accretion tax system would not be perfect, however, if it could not accurately determine increases in the value of property.

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209. The Hohfeldian relationships are those Professor Hohfeld identified as jural opposites—rights/no-rights, privilege/duty, power/disability, and immunity/liability—and jural correlatives—right/duty, privilege/no-right, power/liability, and immunity/disability. *See* Wesley Newcomb Hohfeld, *Some Fundamental Legal Conceptions as Applied in Judicial Reasoning*, 23 YALE L.J. 16, 30 (1913). The Hohfeldian correlatives are most relevant to this Article because they help explain important aspects of the legal relationship between two parties; namely the federal government and taxpayers.

210. The Hohfeldian correlative of liability to pay tax is the government's power to collect the tax. *Id.* at 44–54 (discussing the correlation between powers and liabilities). The Sixteenth Amendment's grant of power to Congress to lay and collect taxes on income is definite. *See* U.S. CONST. amend. XVI. Thus, Congress has the power and right to collect taxes to the extent a person has income. Congress's power to lay and collect taxes on non-income is limited. *See* U.S. CONST. art. I, § 9, cl. 4 ("No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken."). Efforts by Congress to lay and collect tax directly on individuals who do not have income may be an unapportioned capitation tax, which is a direct tax that would exceed Congress's constitutional powers to lay and collect tax. *See* JENSEN, *supra* note 179, at 44–49. Thus, Congress will often have a Hohfeldian disability to collect taxes, which is the correlative of a taxpayer's immunity from paying taxes if the taxpayer does not have income. *See* Hohfeld, *supra* note 209, at 55–58.

With imprecise estimates, the system risks imposing a tax on property owners who do not have a liability to pay tax and not imposing a tax on taxpayers with a liability to pay tax. For example, if the estimate of A_2's property is less than its actual value, the law will fail to tax A_2 to the full extent of his duty to pay tax.[211] If the estimate of A_2's property is greater than the property's actual value, the government will violate A_2's privilege not to pay tax by collecting tax from A_2.[212] Under the assumption that the value of property reflects the property owner's ability to pay tax, imprecise estimates will also fail to accurately determine A_2's ability to pay tax. An equity analysis should consider the consequence of taxing A_2 when the value is less than estimated and not taxing A_2 when the value is greater than estimated.

Simply comparing common characteristics that A_1 and A_2 possess does not adequately identify the inequity that an accretion tax would create in a second-best setting.[213] Instead, the analysis in the second-best setting must account for the tax's effects on the liabilities and immunities of A_1 and A_2, and whether the tax would equally consider A_1's and A_2's abilities to pay tax. If, based on an estimate of the value of A_2's property, A_1 and A_2 were subject to the same amount of tax, then the tax would be an equal treatment of unequals whenever the estimate of A_2's property did not reflect its actual value. On the other hand, if, based on an estimate of the value of A_2's property, A_1 and A_2 were subject to different amounts of tax, the tax would be an unequal treatment of equals whenever the actual value of A_2's property equaled the value of A_1's property. Under a liabilities-and-immunities analysis, the tax A_1 pays will always reflect A_1's liability to pay tax and will never violate his immunity from paying tax. Assuming the estimate of A_2's property will not equal the property's actual value, the tax

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211. If the actual value of A_2's property were \$100,000, then A_2's tax should be based on \$50,000 of accretion. At a 20% rate, A_2 would have a duty to pay \$10,000 of tax on the accretion. An estimate of A_2's property at \$75,000 would result in an imposition of only \$5,000 of tax (i.e., \$25,000 appreciation x 20%). Thus, the imprecise estimate would not reflect A_2's actual duty.

212. If the actual value of A_2's property were \$100,000, then A_2's tax should be based on \$50,000 of accretion. At a 20% rate, A_2 would have a duty to pay \$10,000 of tax on the accretion. An estimate of A_2's property at \$125,000 would result in imposition of \$15,000 of tax (i.e., \$75,000 appreciation x 20%). A_2 had a privilege not to pay tax on the \$25,000 by which the estimate exceeded the actual value of his property. The imposition of a tax on that amount would violate his privilege.

213. A_1 and A_2 are not alike in two respects. First, A_1 holds property that is easily valued while A_2 holds property that is difficult to value. Second, A_1 has \$50,000 of accretion, while A_2 may or may not have \$50,000 or more of accretion. A_1 might, however, argue that equity suggests that he should not pay tax because A_2 does not pay tax. A_1's argument would be valid if (1) the criterion of comparison were the continued holding of property and (2) the law did not grant an absolute privilege not to pay tax to those who continue to hold property. A_1's argument would be somewhat weak because continued holding does not justify the different tax treatment; rather, inability to determine the actual increase in value of A_2's property justifies the treatment. This brief note demonstrates some of the weaknesses of equity discussed above.

A_2 pays will either be less than the full amount of A_2's liability to pay tax or will violate A_2's immunity from paying tax. Thus, under the same assumption, the tax system must choose between treating equals unequally and treating unequals equally.[214]

A symptom of treating equals unequally and unequals equally is that the tax will always be overinclusive or underinclusive. A tax under an accretion tax system based on uncertain values will be overinclusive if the estimated value of A_2's property is greater than the property's actual value.[215] The tax will be underinclusive if the estimated value is less than the property's actual value.[216] Assuming both A_1's and A_2's properties increase in value, an accretion system will be underinclusive if it taxes only A_1's increase in value or if it taxes neither A_1's nor A_2's increases in value.[217] Table 5 illustrates this situation.

214. To the extent the system taxes A_1 and A_2 equally, it will treat unequals equally because the value of A_2's property will be different from the value used to determine A_2's tax. To the extent the system taxes them differently when the actual values of their properties are equal, it would treat equals unequally. If the actual values of A_1's and A_2's property differ, equity suggests that A_1 and A_2 should be taxed differently (i.e., unequals should be treated unequally). The different tax treatment should, however, be in proportion to the difference in their properties' values. *See* Simons, *supra* note 76, at 437–46 (describing the comparative-proportionality right as requiring that if a specified class receives a defined treatment, then a second class should receive a different treatment in proportion to the difference in class). Thus, if the actual increase in value of A_1's property is $50,000 and the actual increase in the value of A_2's property is $75,000, A_1's tax should be two-thirds of A_2's tax. If the tax system is progressive, proportionality rights would require that A_2's tax be greater than 150% of A_1's tax. Under an abilities theory, the different rates applicable to the two parties would be attributable to their different abilities to pay tax. The tax would nonetheless be proportionately equal because the different tax rate would take into account the different abilities. Choosing the correct proportionately different treatment is a matter for vertical equity. Vertical equity may indeed suggest that the tax system should treat unequals unequally. The current discussion focuses on horizontal equity and thus considers only the two stated possible outcomes (i.e., equal treatment of unequals and unequal treatment of equals).

215. If the estimated value of A_2's property is greater than the property's actual value, a tax based on the estimated value of the property would be overinclusive because it will tax nonexistent appreciation.

216. The tax would be underinclusive if it did not tax the difference between the estimated value of A_2's property and the actual value of A_2's property.

217. An accretion tax system that taxes only A_1 would be underinclusive because it would not tax the increase in A_2's property's value. Even though the amount of increase would be difficult to determine, if values increase, A_2 would not be taxed on the uncertain amount of appreciation. If the system taxed neither A_1 nor A_2, it would be underinclusive because increases in value of properties would go untaxed. Furthermore, if the universe of taxpayers were increased to include a seller of property, the system would be underinclusive if it taxed only the seller.

Table 5: Valuation Rationale for Realization Requirement		
	A_1	A_2
Estimated Accretion	$50,000	$0–$100,000
Actual Accretion	$50,000	$25,000
Potential for Overinclusion	$0	$75,000
Potential for Underinclusion	$0	$25,000

In a second-best setting, the tax will always be either overinclusive or underinclusive. An example illuminates this problem. Suppose that, during recess, one of two students throws a rock that breaks a window.[218] The teacher did not see who threw the rock, and the students will not reveal who threw the rock. The teacher may consider three different punishment regimes: (1) punish both students, (2) punish neither student, or (3) randomly choose one student to punish. The non-thrower should have Hohfeldian immunity from punishment, and the teacher should have a disability to punish the student.[219] The teacher would, however, have the power to punish the thrower (and the thrower would have a liability to be punished). The legal relationships between the teacher and her students inform the equity analysis.

The first alternative treats unequals equally and is overinclusive because it punishes the student who did not throw the rock. Thus, the first alternative violates the non-thrower's immunity not to be punished. The second alternative treats unequals equally and is underinclusive because the rock thrower goes unpunished. That alternative does not violate the non-thrower's immunity, but the teacher does not exercise her power to punish the rock thrower. The third alternative could be equitable if the teacher chooses the right student to punish. Otherwise, the punishment treats unequals unequally and is simultaneously overinclusive by punishing the non-thrower in violation of the immunity from punishment and underinclusive by not punishing the wrongdoer.

The basic Aristotelian concept of equity does not inform the analysis, but Rawlsian equity does. The first and third alternatives shock the sense of right and wrong.[220] The first alternative is undesirable because it

218. This example is adapted from an example in Simons, *supra* note 76, at 458.

219. The teacher would arguably have the Hohfeldian power to punish the student.

220. The second alternative may also shock the senses because the rock thrower will go unpunished. Many people would agree, however, that punishing the innocent is generally more damaging than allowing the guilty to go free. *See, e.g.*, WILLIAM BLACKSTONE, 4 COMMENTARIES *358 ("[I]t is better that ten guilty person escape than that one innocent suffer.").

guarantees the punishment of an innocent student and breaches that student's immunity from punishment; the third is undesirable because of the randomness of the selection process. The first alternative and the third alternative—if the teacher punishes the wrong student—violate both Aristotelian equity and Rawlsian equity.[221] Punishing an innocent person treats that person as less than human and fails to recognize the dignity of the innocent. Because the teacher has a disability to punish the non-thrower, under a Hohfeldian analysis, the first alternative is undesirable, and the third alternative is undesirable if the teacher chooses the wrong student. Because the teacher cannot accurately choose the wrongdoer under the third alternative, the third alternative would be undesirable. Thus, the second alternative, which treats unequals equally, is the most desirable alternative.

Accretion taxation raises a similar dilemma. The system may (1) tax both A_1 and A_2 the same, (2) tax neither A_1 nor A_2, or (3) tax only A_1. The first two alternatives treat unequals equally. The first presents the distinct possibility of violating A_2's immunity from the tax. The government has a disability to impose tax unless a taxpayer has income. The government would violate its disability by imposing a tax on A_2 based on an overstated estimate of the value of A_2's property. Although the government may have the power to tax a person with accretion, it is not required to exercise that power. Of the two alternatives—not to exercise a power or to act beyond a power—the better choice is not to exercise a power. Therefore, the first alternative is undesirable because the government would act beyond its power. Because the government would not act beyond its power under the second alternative, it would be an acceptable equal treatment of unequals. The third alternative treats equals (to the extent that the appreciation of A_1's and A_2's properties is equal) unequally because A_2 will have appreciation but pay no tax. The government will not breach a disability by taxing only A_1, and A_1 has a liability to pay tax on his income. Thus, the third alternative would appear to be an acceptable unequal treatment of equals.

Even though equity would permit the third alternative, the realization requirement adopts the second alternative. As a consequence, the tax system treats the holder of property and the seller of property differently, resulting in unequal treatment of equals if the holder and seller had the same amount of accretion. Nonetheless, the government merely fails to exercise the power to tax the holder on known appreciation, but the

221. Professor Greenawalt presents Lord Halifax's firing of an entire typing pool during World War II, when at least one member of the pool was leaking information but he could not determine who, as an example of a situation that would justify treating unequals equally by punishing the innocent along with the guilty. *See* Greenawalt, *supra* note 165, at 1174 ("[A]dministrative convenience may require the same treatment of persons whose difference in relevant characteristics is clearly perceivable at the time.").

government does not act beyond its power under the system. Even though not taxing appreciation may violate Aristotelian equity by treating likes differently, it is a palatable alternative because it avoids difficult property-valuation challenges and does not require the government to act beyond its taxing power. Thus, difficulty in valuing property is one justification for not taxing appreciation. The other justification for not taxing appreciation is illiquidity.

2. Illiquidity

The illiquidity of A_2's property also distinguishes A_2 from A_1. For the sake of analysis, assume that the value of A_2's property is \$100,000, the same value as A_1's property. Assume that in the first-best setting A_1 can liquidate his property without incurring transaction costs and without affecting the value of the property. In the second-best setting, assume that A_2 must pay transaction costs to liquidate his property.[222] Further assume that A_2 must pay \$2,000 in transaction costs to sell enough property to meet a \$6,000 tax obligation. After paying tax and transaction costs, A_2 would have \$92,000 of property. A_1, who does not have to pay transaction costs, would have \$94,000 of property after paying taxes. A_2 would therefore be \$2,000 worse off than A_1 if A_2 were required to pay the tax. As a result of the tax, A_1 and A_2 go from a state of similarity to a state of dissimilarity.[223] Table 6 sets forth the economic situations of A_1 and A_2 under this scenario.

Table 6: Liquidity Rationale for Realization Requirement (Effect of Transaction Costs)

	A_1	A_2
Value Before Payment of Tax	\$100,000	\$100,000
Disposition Costs	\$0	\$2,000
Tax	\$6,000	\$6,000
Value After Payment of Tax	\$94,000	\$92,000

Selling a portion of property may adversely affect the value of the portion of the property retained. For instance, A_2's property might be an

222. For example, if the property is land, A_2 will have to pay for a survey to subdivide and sell a portion of the property. A_2 will also incur costs to transfer title to the property. If the property is a building or machinery, liquidating a portion of the property may be impossible, and A_2 may be required to sell the entire property to pay tax.

223. This assumes that A_1 and A_2 derive the same utility from their property.

office building and an adjacent parking lot. Together the building and parking lot are worth $100,000. To raise the $6,000 needed to pay tax and the cost of subdividing the property, A_2 must sell the parking lot for $8,000.[224] Although A_2 receives only $8,000 on the sale of the lot, the building without the parking lot is worth only $80,000.[225] Therefore, paying the $6,000 tax costs A_2 $20,000. After subdividing the property, selling the lot, and paying the tax, A_2 has $80,000 of property. On the other hand, the value of A_1's property in the ideal setting does not diminish as a result of selling a portion to pay taxes. Therefore, following the payment of tax, A_1 has $94,000 of property. Table 7 illustrates the economic consequence of this scenario.

Table 7: Liquidity Rationale for Realization Requirement (Effect of Devaluation)

	A_1	A_2
Value Before Payment of Tax	$100,000	$100,000
Disposition Cost	$0	$2,000
Tax	$6,000	$6,000
Devaluation	$0	$12,000
Value After Payment of Tax	$94,000	$80,000

Under a utility theory, a tax on illiquid property violates equity because the tax causes parties whose position was the same before the tax to be different after the tax.[226] In fact, a tax on appreciation of liquid property, but not on the appreciation of illiquid property, would also violate equity under the utility theory. If A_1 had to pay tax, but A_2 did not, then after the tax, A_1's property would be less valuable than before, while the value of A_2's property would remain the same. Thus, between A_1 and A_2, an equitable result would obtain if neither party paid tax.

This analysis demonstrates that valuation and liquidity warrant both the realization requirement and the differing treatment of holders of certain

224. This value includes the $6,000 tax and the $2,000 transaction fees.

225. This result is not surprising. After all, a building without a parking lot is worth less than a building with a parking lot because the owner cannot guarantee parking for the building's occupants. Thus, the value of the building decreases when A_2 sells the lot. The lot standing alone may also be worth less, so A_2 cannot fetch a price by selling the lot alone that he would have obtained if he had sold the lot with the building.

226. *See supra* note 186 and accompanying text.

property compared to other taxpayers, such as sellers, whose consideration received in exchange for property is liquid and easy to value.[227] The analysis also demonstrates that the realization requirement is not justified with respect to all property to which it applies. The realization requirement should apply only to property that is either difficult to value, illiquid, or both. Thus, equity does not require not taxing the appreciation of certain types of property, such as publicly traded securities, that are liquid and easily valued.

To the extent that ease of valuation and liquidity justify the realization requirement, they should justify nonrecognition for transactions involving property that is illiquid or difficult to value. The analysis can test for those characteristics by comparing other taxpayers in a first-best setting to taxpayers in a second-best setting. For example, in the first-best setting, Beatrice (B_1) transfers liquid property in exchange for liquid property; in the second-best setting, Beatrice (B_2) transfers illiquid property for illiquid property. Most exchanges are multiple-party exchanges, so the analysis assumes that in both the first-best setting and second-best setting Beatrice can accurately value the property transferred and the property received.[228] Thus, the analysis focuses solely on liquidity.

If B_2 lacks the power to access exchange proceeds as part of the exchange, then the exchange in the second-best setting raises the same issues that continued investment raises for A_2. B_2 would incur costs to sell a portion of the relinquished property or a portion of the replacement property, and such a sale would diminish the value of the retained property. B_2's exchange, however, is a multiple-party exchange; thus, B_2 could access a portion of the sale proceeds to pay taxes without incurring any transaction costs or devaluing the proceeds.[229] Generally, exchangers

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227. From an efficiency standpoint, a taxpayer would be less likely to acquire illiquid property if the law required payment of taxes on increases in the property's value. The transaction costs required to liquidate illiquid property would influence taxpayers to purchase liquid property, *ceteris paribus*. *See* Shaviro, *supra* note 27, at 27 ("[T]he Time One analysis suggests attempting to minimize the influence of tax considerations on taxpayer decisions to make a particular investment.").

228. In a multiple-party exchange, an exchanger transfers relinquished property to one party and acquires replacement property from another party with a qualified intermediary facilitating the exchange. *See supra* notes 49–57 and accompanying text. Assuming that the relinquished-property buyer and the replacement-property seller are not related to the exchanger and the transactions are otherwise at arm's length, the price the buyer pays for the relinquished property and the price the seller receives for the replacement property will reflect the properties' fair market values. Thus, valuation generally is not an issue in most section 1031 exchanges. *See* Kornhauser, *supra* note 2, at 443 (arguing that valuation does not provide a valid argument even in a direct swap).

229. To qualify for the qualified-intermediary safe harbor, B_2 would have to assign her rights to receive the proceeds for Property *B* to a qualified intermediary. *See* Treas. Reg. § 1.1031(k)-1(g)(4)(v) (as amended in 2002). The assignment of rights helps create a fictitious exchange between B_2 and the qualified intermediary, and prevents B_2 from accessing the exchange proceeds.

will be able to value property and have access to liquid assets during the exchange interstice, eliminating the liquidity problem.

Referring back to a previous example, the same analysis would apply to Cloy, who exchanges non-like-kind property.[230] Neither valuation nor liquidity concerns arise for Drew, regardless of the setting in which he sells his property.[231] In both situations, Drew can value his property, and the cash he receives is liquid. Thus, the factors that justify the realization requirement generally do not justify relieving exchangers and sellers of tax liability. Even though valuation and liquidity do not support not taxing like-kind exchanges, comparative equity suggests that tax law should treat exchangers of like-kind property similarly to holders of property.

D. *Comparative Equity*

Once tax law treats property holders differently from other taxpayers, the system will have an equity split.[232] Comparative equity should determine the placement of the equity split.[233] Comparative equity provides that if a particular group receives a certain treatment, then some other group should receive the same treatment.[234] An example contrasts a privilege created by law with a privilege derived from comparative equity. A state sets its speed limit for freight trucks at seventy miles per hour. Thus, freight trucks have a privilege to travel at seventy miles an hour but may travel more slowly. The state also provides that drivers of passenger vehicles cannot pass freight trucks or travel faster than seventy miles per hour.[235] The law does not determine the speed limit for passenger vehicles

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Before assigning rights to create the fiction, however, B_2 could access the proceeds without incurring significant transaction costs and devaluing property. A smaller amount of exchange proceeds may affect the size and type of replacement property B_2 could acquire, which might mean the replacement property will not be adequate to replace Property *B*. That insufficiency of the replacement property is different, however, from the liquidity argument. To the extent diminished purchasing power could be a valid argument for not taxing exchanges, it might also apply to property sales. That possibility is a topic for another discussion. *See* Jensen, *supra* note 25, at 204 (recognizing that an exchanger may exchange from an illiquid property into a liquid property, thus undermining illiquidity arguments, at least in part).

230. *See supra* text accompanying notes 180–82 and Table 1.

231. *See supra* text accompanying notes 178–82 and Table 1.

232. Apart from equity consequences, Professor Shaviro also recognized that once the system deviates from the preferred broad tax base, efficiency may suggest varying tax treatment based on tax elasticity. *See* Shaviro, *supra* note 27, at 4.

233. *See* Simons, *supra* note 76, at 416–52 (describing the normative significance of comparative equity rights).

234. *See id.* at 424 (providing examples of explicit and implicit comparative rights of specified classes in relation to the treatment of other specified classes).

235. The reason for such a law may be that the lawmakers believe that drivers of freight trucks are more sensitive to adverse driving conditions and will slow down as needed to maintain a safe driving speed.

in absolute terms. Instead, the speed limit for passenger vehicles will depend upon the slowest moving freight truck traveling directly in front of the passenger vehicle. This is an example of comparative equity. To determine the speed limit for a passenger vehicle, one often must determine the speed of the slowest moving freight truck.

Comparative equity may be explicit or implicit. Explicit comparative equity provides that if one specified class receives a benefit or burden then other specified classes shall receive the same benefit or burden.[236] For example, the Privileges and Immunities Clause of the Constitution grants to nonresidents the rights that a state grants to residents.[237] Thus, a state may not impose a tax on nonresidents that does not apply equally to residents of the state.[238] Nonresidents have the explicit right to receive the same benefit of tax exemption that residents receive. The passenger vehicle speed limit in the example is also governed by explicit comparative equity.

On the other hand, implicit comparative equity provides that one class shall be subject to the same obligation that another class bears if no sufficient reason exists for treating the parties differently (or if a sufficient reason exists for treating them similarly).[239] Stated differently, implicit comparative equity suggests that two parties should be treated the same if the reasons for treating one party a certain way apply to both parties.[240] A comparative equity right is therefore implicit if it depends on the purpose of the rule.[241] For example, a state law governing winter travel in mountainous terrain may provide that all vehicles must use adequate traction equipment (e.g., tire chains) when traveling over a particular summit. If this rule seeks to ensure that all vehicles have proper traction when traveling over the summit, then the law should require a person with snow tires to use tire chains if the snow tires do not provide traction similar to that provided by tire chains.

Comparative equity has normative significance because the law is

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236. *See* Simons, *supra* note 76, at 424.

237. U.S. CONST. art. IV, § 2, cl. 1.

238. *See, e.g.*, Austin v. New Hampshire, 420 U.S. 656, 660–66 (1975) (striking down a New Hampshire tax that, in application, taxed only nonresidents); Toomer v. Witsell, 334 U.S. 385, 395, 406 (1948) (holding invalid a shrimp fishing boat license fee that varied depending upon whether the boat was owned by a resident or nonresident of South Carolina); Ward v. Maryland, 79 U.S. (12 Wall.) 418, 430 (1870) ("[I]nasmuch as the Constitution provides that the citizens of each State shall be entitled to all privileges and immunities of citizens in the several States, it follows that the defendant might lawfully sell, or offer or expose for sale, within the district described in the indictment, any goods which the permanent residents of the State might sell, or offer or expose for sale in that district, without being subjected to any higher tax or excise than that exacted by law of such permanent residents.").

239. *See* Simons, *supra* note 76, at 424.

240. *See id.*

241. *See id.* at 425.

uncertain without comparing the benefits or burdens of one party to those of another. For instance, in the first example, the speed limit for passenger vehicles depended upon the actual speed of the slowest freight truck. Analogously, a state's power to tax nonresidents depends upon how it taxes residents. In the snow tire example, the adequacy of snow tires for traveling the road is uncertain until the traction of the snow tires is compared to the traction of tire chains. Implicit comparative equity also depends upon the liability or right being imposed upon or granted to another party.[242]

A settled rule in tax law states that holders of property should pay tax on the appreciation of property only after they dispose of the property. The reason for that rule lies in the idea that taxing appreciation of property that is illiquid or difficult to value creates inequitable results.[243] Under implicit equity, once the system exempts appreciation from taxation, the system should likewise exempt the exchange of any property that is illiquid or difficult to value. As demonstrated above, however, that will seldom be the case with exchange property. Implicit equity should also require, however, that parties be treated the same if different treatment would affect the behavior of the party to whom the rule does not explicitly apply. Potential behavior alteration would be a sufficient reason for not treating holders and exchangers differently. Thus, the tax treatment of exchangers depends upon the tax treatment of holders, if treating exchangers differently from holders will affect the decision to exchange. In solving the equity conundrum, the analysis turns to efficiency to determine whether to tax exchangers like holders or sellers.

Efficiency suggests that "decisions within broad subcategories of consumption or investment may tend to be more elastic than decisions across subcategories. . . . This principle immediately brings to mind the nonrecognition provisions that require a quantum of resemblance between the taxpayer's new and old investments (such as like-kind exchanges)."[244] Under the significance-of-change principle, a property owner would be less likely to sell and reinvest in similar property if the transaction were subject to tax: "The similarity of the items exchanged suggests weaker nontax reasons for exchanging them, and thus a greater likelihood that taxing such exchangers would merely deter them, rather than raise revenue."[245] The realization requirement gives property owners an incentive to hold property to avoid tax. If the property owner will be in a similar situation following an exchange, the tax on such a transaction will deter the exchange. Thus, to promote the exchange of like-kind property, tax law must grant nonrecognition on such transactions.

242. *See id.* at 424.

243. *See supra* notes 205–08 and accompanying text.

244. Shaviro, *supra* note 27, at 34.

245. *Id.* at 45.

As exchange property becomes less similar, the support for nonrecognition decreases. Nontax consequences are more likely to affect investment in property across subcategories.[246] Thus, such exchanges are less tax-elastic. Because tax would be less likely to affect the decision whether to exchange property for dissimilar property, taxing such transactions is more efficient than taxing tax-elastic transactions.[247] Efficiency supports like-kind exchanges only to the extent that the definition of like-kind property is sufficiently narrow. The breadth of the definition of like-kind property should depend on the tax elasticity of the decision to acquire replacement property. That decision in turn should depend upon whether a property holder can accomplish tax-free a change in the form of property that would be similar to a change accomplished by an exchange.

VI. CONCLUSION

The answer to the equity conundrum turns on the proper treatment of property holders. Equity suggests that holders of difficult-to-value and illiquid property should not be taxed on the appreciation of their property. The proper treatment of exchangers of like-kind property depends upon that rule. Once the system exempts appreciation from taxation, an equity split results. The system must tax exchangers of like-kind property similarly to either property holders or property sellers and exchangers of non-like-kind property. In the second-best setting, the proper criterion for applying equity relies on the effect the tax would have on an exchanger's decisions. Taxing exchangers of like-kind property like property sellers and exchangers of non-like-kind property would discourage like-kind exchanges. Thus, the solution to the equity conundrum requires that the law not tax like-kind exchanges.

Even though equity suggests that exchangers of like-kind property should be taxed like property holders, it does not support some aspects of section 1031. For example, it does not support a definition of like-kind property that allows an exchanger to transform an investment into something that a holder of property could not transform the property into tax-free. Thus, equity suggests that section 1031 should not allow an

246. *Id.* at 34 ("For example, I may be more easily swayed by cost factors between two urban apartments than between either and a suburban home, and between all three of these housing choices than between any of them and the option of economizing on housing and taking expensive vacations instead.").

247. *See id.* at 34 ("Nontax significance matters because, the greater the range and importance of the nontax implications of a decision, the more likely the taxpayer is to have a strong preference, and the less likely the decision is to be in such close equipoise that tax considerations will tip the balance.").

owner of a fee interest in real property to exchange that property for a partial real estate interest or a concurrent interest in real property. The law should be modified to remove that inequity.