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# The Section 1031 Qualified-Use Requirement

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# THE SECTION 1031 QUALIFIED-USE REQUIREMENT

*Bradley T. Borden*[*]

## ABSTRACT

*Section 1031 allows owners of real property to dispose of their property and acquire replacement real property tax-free, and it is one of the most widely used transactional-planning provisions in federal tax law. With the variation in size of the transaction to which section 1031 applies comes varying levels of advice available to property owners. The significant variation in advice that property owners receive affects the actions that they take with respect to their property. Such variation appears to be most pronounced with respect to section 1031 exchanges that occur in proximity to business transactions (i.e., contributions to and distributions from business entities). Some advisors claim that the exchange and proximate business transactions must be separated by some period or separated by a change in tax years. This Article shows that such advice has no support in the law.*

*Despite the lack of support for such advice, the advice persists to the detriment of property owners, especially those who are under-represented. The problem is exacerbated by infrastructure that exists in the section 1031 space to facilitate section 1031 exchanges. Almost every exchange is facilitated by a section 1031 qualified intermediary. The largest section 1031 qualified intermediaries facilitate tens of thousands of exchanges each year. The exchange agents and others working within qualified intermediaries are in contact with tens of thousands of property owners each year. To economize transaction costs, property owners will often look to qualified intermediaries for advice regarding section 1031 exchanges.*

*Because of the wide variation in property owners that engage in section 1031 exchanges and the pressure to keep costs manageable, advisors may attempt to provide general, simplified descriptions of the cases and IRS rulings that consider the qualified-use requirement. The advice may also be designed to minimize property owners' tax risk. That approach is undermined by the significant variety of transactions that raise the qualified-use requirement. Case law and IRS rulings span various types of qualified-used transactions, each fitting into a category that is governed by its own set of rules. The relevance of qualified-use authority to any given situation depends upon the facts of the authority and the facts of the given situation.*

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*Thus, not all qualified-use authority is created equal or treated equally with respect to the various situations that raise the qualified-use requirement.*

*This Article brings order to the qualified-use issue by describing the legally prescribed analysis that applies to tax-law questions such as the section 1031 qualified-use requirement. By categorizing the qualified-use cases and rulings according to transaction type, the Article shows that the law governing the qualified-use requirement is rational and certain with respect to several types of qualified-use exchanges. The failure of property owners and their advisors to accurately understand the law governing the qualified-use requirement could result in multiple types of risk that extend beyond tax risks. First, advice to hold property for a period under the mistaken belief that holding property longer increases the likelihood of satisfying the qualified-use requirement can create transaction risks. For instance, property could lose value, or disagreements among co-owners could arise while property is held longer under the misperception that doing so reduces tax risk. Second, advising clients to hold property longer than is needed with no authority to support such advice exposes advisors to advisory risk. Such risks are reduced when advice is based upon relevant authorities.*

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## I. INTRODUCTION

Section 1031 allows property owners to transfer property and receive like-kind property without incurring taxable gain,[1] and it is perhaps the most widely used transactional tax-planning tool available to property owners. Because of its universal appeal, property owners transferring and acquiring property of all sizes stand to benefit from section 1031. Those benefits can be jeopardized, however, if the information and advice property owners receive regarding section 1031 is not accurate. To qualify for nonrecognition of gain under section 1031, a transaction must be an exchange (the exchange requirement) of real property (the real-property requirement) that is like-kind (the like-kind requirement), and that is held by the exchanger for productive use in a trade or business or for investment (the qualified-use requirement[2]).[3]

The qualified-use requirement becomes an issue when an exchange occurs in proximity to another transaction or when an exchanger converts the use of exchange property before or after an exchange. This Article refers to any exchange that raises questions regarding the qualified-use requirement as a "qualified-use exchange." The qualified-use requirement is susceptible to misunderstanding, confusion, and misinformation. As a result, property owners often receive bad advice related to the qualified-use requirement. Such bad advice can lead to misinformed and costly decisions by property owners.

One particularly odious practice is suggesting that property owners must hold property for a period of time to satisfy the qualified-use requirement. Commentators make such a claim in writings and continuing education presentations.[4] This misinformation gets picked up by advisors, who then pass it on to their property-owner clients. Reliance on such misinformation can have the following negative effects: (1) property owners hold property longer than they would otherwise and suffer economic loss or miss out on investment opportunities;[5] (2) parties to a transaction create overly complex

1. I.R.C. § 1031(a)(1). All Section references are to the Internal Revenue Code as amended, unless stated otherwise.

2. This can also be called the "use requirement," *see, e.g.*, BRADLEY T. BORDEN, TAX-FREE LIKE-KIND EXCHANGES, ¶ 3.3[2] (2d ed. 2015), and the "holding requirement," *see, e.g.*, Magneson v. Commissioner, 753 F.2d 1490, 1496 (9th Cir. 1985).

3. I.R.C. § 1031(a)(1); BORDEN, *supra* note 2, at ¶ 3.1.

4. *See, e.g.*, Gary A. Kravitz, *1031 Drop and Swap: Breaking up is Hard to Do*, MADDIN HAUSER 27TH ANNUAL TAX SYMPOSIUM, § I.C.1.b. (Oct. 27, 2018), https://maddinhauser.com/wp-content/uploads/2020/11/05-MH-27thTaxSymposiumOutline-1031_Exchanges-outline-GAK.pdf ("Must consider the length of time the taxpayer held the Relinquished Property before the 1031 exchange and the length of time the taxpayer held the Replacement Property after the 1031 exchange ('Holding Period'). There is no bright-line rule for how long assets must be held. Two years is considered safe, two months would be considered risky.").

5. For instance, on the acquisition-side of an exchange, an exchanger who receives replacement property may, on the advice of counsel, hold it for two years before contributing it to a limited liability company for development and miss out on economic activity that could have occurred within that two-year period. Alternatively, on the disposition-side of an exchange, parties may

transactions that may add to transaction costs,[6] create non-tax risks and uncertainty,[7] and raise unintended tax risk or unnecessary tax costs;[8] and (3) property owners report gain on transactions that qualifies for section 1031 nonrecognition.[9] The costs of misinformation about the qualified-use requirement are primarily borne by property owners who forego legitimate transactions, incur needless structuring expenses, end up in other troubling circumstances, or unnecessarily report gain as a result of receiving faulty advice.

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attempt to complete an exchange within a limited liability company instead of dividing. Unwarranted delays on either side of an exchange can increase tax risks, create complexity, and introduce non-tax risks into the structure. *See infra* text following note 10.

6. For instance, instead of acquiring replacement property and contributing it to a limited liability company to be developed, an exchanger may acquire a tenancy-in-common interest in property with a developer and then enter into a very complex tenancy-in-common agreement that is designed to avoid arrangements that would cause the co-ownership structure to be a partnership for tax purposes. The resulting arrangement is overly complex and runs the risk of being treated as a partnership for federal income tax purposes. If so treated, the exchanger would most likely be treated as acquiring an interest in real property and immediately contributing it to a partnership. That result is the same as the exchanger intentionally acquiring the interest and contributing it to a limited liability company. *See* Bradley T. Borden, *TICnerships*, 18 BROOK. J. CORP. FIN. & COMM. L. 587 (2024).

7. For instance, a tenancy-in-common arrangement that complies with Rev. Proc. 2002-22 limits the tenure of a manager and the types of services a manager can provide and requires that the co-owners retain the right to sell their interests in the property and to partition the property. With such an arrangement, all co-owners are subject to the risk that a co-owner will become disaffected and threaten to the partition the property. If an exchanger acquires a tenancy-in-common interest to hold long-term, the exchanger is subject to the terms of the tenancy-in-common arrangement, which, in many cases, creates such non-tax risks that do not exist for investors who hold property in a limited liability company or limited partnership. The situation described *supra* note 5 also illustrates how structuring a transaction to delay transfers can create non-tax risks, such as increasing the likelihood of co-owner discontent. Advisors who believe incorrectly that the property must be acquired from a partnership and held for some period of time to satisfy the section 1031 requirements could advise clients that the partnership must distribute property at some time prior to the disposition of the property. That requires the property to be held as a tenancy-in-common and may require lender consent if the property is subject to a mortgage. If parties do not obtain lender consent, the distribution could be an event of default, giving the lender the right to call the loan. If the sale does not close, the parties must address the loan default.

8. For instance, advising a client to enter into a complex tenancy-in-common arrangement instead of acquiring property and immediately contributing it to a limited liability company creates a risk that the arrangement will be recast as a partnership for federal income tax purposes. If classified as a partnership, a purchaser's acquisition of an interest in the entity may not qualify as valid section 1031 replacement property. *See* Borden, *TICnerships*, *supra* note 6, at 661–76 (discussing the various possible tax outcomes of purchases of interests in tenancy-in-common arrangements that are TICnerships). Thus, advising a client to hold property in a complex tenancy-in-common arrangement, which would be required if the client was advised to hold the property long-term in such an arrangement, may cause the acquisition of the interest to fail to satisfy the section 1031 requirements. *Id.* at 678–81.

9. For instance, an exchanger could be advised that failure to hold replacement property for an arbitrary period before converting it to personal use caused the exchange to fail to qualify for section 1031 nonrecognition.

Here is an example of how bad advice can cause non-tax costs.[10] The members of a partnership decide to transfer property, but they would like to divide the partnership prior to the transfer so each partner can separately do a section 1031 exchange. Contrary to the weight of authority on this issue, their advisor tells the partners that if they divide the partnership prior to the exchange, there is a risk that the division will jeopardize their exchange. The advisor suggests that the partners remain in the partnership, have the partnership sell the relinquished property, acquire three replacement properties as selected by the respective partners, hold those replacement properties for two years, and then divide. The partners, not knowing any better, move forward with the transaction in that manner. Shortly after the partnership completes the exchange and holds multiple replacement properties, one of the partners passes away, and the heirs object to the plan to liquidate the partnership by distributing the properties as planned by the original partners. Instead of receiving the property that the decedent would have received, the heirs want to receive the property that the original partners intended to be transferred to the other partners. Alternatively, the heirs suggest that the partnership sell the property and liquidate. Because the heirs get a stepped-up basis upon the death of the decedent, they are unconcerned about recognizing gain on the transaction. The partnership agreement is silent regarding the distribution of property on dissolution.

This simple example illustrates that transactions have significant economic and transactional components. Tax risk is just one of several variables that must be considered in planning the transaction. The advisor in the hypothetical appeared to give tax advice that the advisor considered to be conservative because it appeared to provide the lowest risk that the section 1031 nonrecognition of the transaction would be challenged. The advisor failed, however, to account for the transactional risk that ended up being very costly to the partners, who incurred significant costs to settle the division of the partnership with the heirs, who unexpectedly became members of the partnership.

Confusion regarding the qualified-use requirement appears to be attributable to multiple factors. Such confusion derives in part from efforts to simplify explanations of the law and efforts to distill and apply general rules to all types of exchanges that could raise questions about the qualified-use requirement.[11] Simplification is a problem if it results in misrepresenting the

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10. This example is a variation of a real-life transaction. It is considered in greater detail below. *See infra* Part V.C.4(b).

11. The effort to simplify may be due to the nature of the section 1031 qualified intermediary industry. Qualified intermediaries facilitate section 1031 exchanges, providing an essential service to exchangers. *See* Treas. Reg. § 1.1031(k)-1(g)(4). Many of those exchangers are engaging in transactions that do not have sufficient tax-saving potential to justify hiring expensive tax counsel. Instead, exchangers and their real estate representatives often rely upon qualified intermediaries for tax advice regarding the exchange. Qualified intermediaries do not want to disappoint their clients by refusing to offer tax advice and feel pressure from competition to sound knowledgeable about

law. Because qualified-use exchanges are diverse, simplified, general statements cannot adequately apply to all qualified-use exchanges. Thus, simplification in this area should be limited to specific types of transactions to which they might apply. This Article takes the approach of complicating the thinking to better appreciate the nuances in the several different qualified-use authorities. By complicating the analysis, this Article reveals how the several qualified-use rulings fit within a taxonomy and relate to each other.

Confusion also appears to derive from the intricacies of tax-law analysis and the failure of non-attorney advisors and general-practice attorneys to apply tax-law analysis. Tax law includes unique analytical tools that taxpayers and advisors must use to determine the strength of support for a reporting position.[12] In areas where the law may not be clear or may not appear clear, tax-law analysis requires advisors to weigh various authorities to provide informed advice regarding the strength of support for the reporting position.[13] In other words, tax-law analysis does not treat all legal authorities equally, so the relative importance of the various authorities must be determined with respect to any transaction that comes under consideration. Without such analysis, advisors cannot accurately convey the law regarding the qualified-use requirement to their clients. Instead, they may inadvertently draw from an authority that has little or no weight and disregard authorities that are relevant and authoritative, thereby rendering inaccurate advice. Because tax-law analysis is essential to understanding the qualified-use requirement, a companion article to this one explains the analysis required by tax law, illustrates how to use it, and specifically, how to use it to draw conclusions regarding the qualified-use requirement.[14] Tax-law analysis also requires using the correct analytical tools. For instance, the analysis requires understanding basic concepts such as facts-and-circumstances tests and when such tests do and do not apply.[15]

Confusion may also stem from an unsystematic reading of the authority and the failure to recognize that several cases and rulings that address the qualified-use requirement are based on and limited to the specific fact

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section 1031. Thus, qualified intermediaries find themselves providing tax advice to many exchangers who are not represented by a tax advisor. The fees qualified intermediaries charge do not justify them devoting time and resources to fully understand the numerous aspects of complex exchanges or to provide in-depth advice. Working within those parameters, qualified intermediaries often resort to providing general, simplified advice. Such advice may include, "the most conservative approach is to hold the property for at least two years before or after an exchange" or "intent is measured at the time of the exchange, and the timing of an acquisition or disposition shortly before or after the exchange shows the intent does not satisfy the qualified-use requirement." This Article illustrates how such simplified statements are not supported by the law in many contexts.

12. *See* Treas. Reg. § 1.6662-4(d)(3)(i).

13. *See id.* § 1.6662-4(d)(3)(ii).

14. Bradley T. Borden, *Tax-Law Analysis*, 18 BROOK. J. CORP. FIN. & COMM. L. 385, 391–98 (2024) [hereinafter *Tax-Law Analysis*].

15. *Id.* at 400–06.

situation presented in the case. The applicability of an authority depends upon the facts to which it applies. The rulings that address the qualified-use requirement consider diverse fact situations, and rulings are only significant to a transaction that has facts in common with the ruling. Thus, a ruling with distinguishable facts is not relevant to a situation under consideration, particularly when another ruling has facts in common with the situation under consideration. In such situations, the two rulings should not be applied equally to the situation, and they should not be amalgamated to create some general rule.

To alleviate the confusion, this Article undertakes to complicate, not simplify, the analysis. By so doing, it unravels the law, identifies categories of transactions in which the qualified-use requirement is relevant, and groups the case law according to those categories. That grouping clarifies the scope of rulings. The qualified-use requirement often arises when an exchanger acquires property in proximity to transferring it as part of an intended section 1031 exchange or acquires it as part of an intended section 1031 exchange and then transfers it.[16] Questions regarding the qualified-use requirement also arise when the purpose for holding exchange property at some time before or after an exchange is personal or primarily for sale. In particular, this Article groups authority that considers the qualified-use requirement into one of two general categories: (1) exchanges and proximate business transactions and (2) exchanges and proximate general transactions.

Exchanges and proximate business transactions include exchanges that occur in proximity to contributions to and distributions from entities. Exchanges and proximate general transactions include exchanges that occur in proximity to all other types of transfers and conversions of property to or from property held for personal use or primarily for sale ("disqualified use") to or from property held for productive use in a trade or business or for investment ("qualified use"). Every case and ruling in which the qualified-use requirement was at issue falls within one of these categories. Each category includes multiple groups of exchanges, with subgroups of transactions in each group and types of transactions in some of the subgroups. The classification of the cases of rulings in this manner reveals that specific rules apply to each subgroup and type of transaction. Using the law applicable to a particular type of transaction provides certainty with respect to the tax treatment of such transaction.

Categorizing the cases and rulings demystifies the qualified-use requirement by showing that the body of law governing the qualified-use requirement is finite, so cases and rulings can be numbered, deconstructed, and compared based upon several different variables. That comparison helps

16. This Article uses the term "exchanger" to refer to any person who transfers property or acquires property as part of a transaction that the person would like to have qualify for section 1031 nonrecognition. Whether the transaction qualifies for section 1031 nonrecognition is immaterial to the Article's designation of the person as an exchanger.

illustrate that variables such as the time property is held and the tax year during which property is acquired and transferred are not significant factors in the courts' and IRS's decisions. Instead, the most important factor is the type of transaction under consideration.

This Article proceeds as follows. Part II presents the classification of qualified-use exchanges, providing a foundation for analyzing the law that applies to each type of transaction. Part III begins the analysis of cases and rulings that apply to exchanges that occur in proximity to business transactions. That analysis establishes that, as a matter of law, an exchanger satisfies the qualified-use requirement if the property is exchanged before or after a tax-free contribution or distribution to or from an entity. Part IV examines the cases and rulings that consider exchanges and proximate general transactions. The types of transactions under this category are more varied than the types of exchanges and proximate business transactions. The law governing most of the types of transactions appears to be fairly settled, but it remains unsettled with respect to one type of transaction, for which the IRS has created safe-harbor guidance that property owners are free to reject or rely upon as they deem appropriate. Part V presents general observations that relate to the qualified-use requirement and addresses various specific misunderstandings regarding the qualified-use requirement that the Author has encountered over more than two decades of working, writing, and speaking in this area. Part VI concludes.

## II. CLASSIFICATION OF QUALIFIED-USE EXCHANGES

Classifying qualified-use exchanges eliminates transaction-ambiguity. Transaction-ambiguity is manifest in one of three ways: (1) the failure to recognize distinctions among the various types of qualified-use exchanges; (2) the tendency to speak generally about the qualified-use requirement as though it applies in the same manner to all exchanges; and (3) the inclination to develop and apply general platitudes or shortcuts to all types of qualified-use exchanges. Transaction-ambiguity impedes identifying and applying the appropriate case law and rulings to situations that have facts in common with such case law or rulings. Transaction-classification eliminates transaction-ambiguity by distinguishing the various types of qualified-used exchanges and facilitating the accurate application of relevant law to common fact situations. Transaction-classification also illustrates that there is no one-size-fits-all general rule that applies universally to all qualified-use exchanges, thereby enabling advisors to speak specifically about identifiable transactions.

### A. PROGENY OF TRANSACTION-AMBIGUITY

An examination of some of the causes of disagreement in this area illustrates that transaction-classification can alleviate misunderstanding and provide clarity.

#### 1. *Holding-Period Confusion*

A significant point of disagreement regarding the qualified-use requirement is whether an exchanger must hold property for some minimum period to satisfy the qualified-use requirement. Some commentators claim there is a two-year-holding-period requirement,[17] others claim that holding exchange property for some period increases the likelihood that it will satisfy the qualified-use requirement,[18] others claim that the two-year holding period

17. *See, e.g.*, RIA, ¶ I-3099 HOW THE HELD FOR PRODUCTIVE-USE OR FOR INVESTMENT RULES HAVE BEEN APPLIED TO VARIOUS LIKE-KIND EXCHANGES, FEDERAL TAX COORDINATOR (2nd ed. 2024) ("IRS ruled that the two-year period is sufficient to ensure that the residence to be acquired will meet the holding period test prescribed by IRC § 1031.") (citing I.R.S. Priv. Ltr. Rul. 84-29-039, *discussed infra* text accompanying notes 177–178, 313–322); Brian S. Masterson, *Held for Productive Use in a Trade or Business or for Investment*, 2 TUCKER ON TAX PLAN. REAL EST. TRANS. § 18:5 (2023) ("It is recommended that property be held for productive use in a trade or business or for investment purposes at least two taxable years before a like-kind exchange is attempted."); Bradford Updike, *Exploring the Frontier of Non-Traditional Real Estate Investments*, 40 CREIGHTON L. REV. 271, 303 (2007) ("In view of previous rulings, a more workable standard might be for the Service to adopt a safe-harbor favorable to the taxpayer in cases in which the co-owned property has been held in tenancy for at least two years."); William T. Carman & Glen E. Carter, *Accounting Issues*, 2 J. OF P'SHIP TAX'N 179, 185 (1985) ("In Letter Ruling 8429039, the Service ruled that where a taxpayer stated that it would hold property received in an exchange for at least two years prior to selling it, such period was sufficient to qualify the exchange under Section 1031(a)."); *Holding Guidelines for 1031 Exchange Properties*, EXETER 1031 EXCH. SERVS., LLC, https://www.exeterco.com/holding_guidelines_for_1031_exchange_property (last visited Feb. 25, 2024) ("[I]n one private letter ruling the Internal Revenue Service has stated that a minimum holding period of two (2) years would be sufficient to meet the Qualified Use Test."); *1031 Exchange Residential Property: Everything Real Estate Investors Need to Know*, NNN DEAL FINDER (Dec. 2023), https://www.buynnnproperties.com/1031-exchange-residential-property/ ("During the two years immediately preceding the exchange, the property should not have been acquired through a previous 1031 exchange."); *1031 Exchange Safe Harbor Rules: What You Need to Know*, REALIZED (Dec. 15, 2021), https://www.realized1031.com/blog/1031-exchange-safe-harbor-rules-what-you-need-to-know ("You must have held the asset for a minimum of two years. This is called the 'qualifying use' period.").

18. *See, e.g.*, J. Martin Burke & Michael K. Friel, *To Hold or Not to Hold:* Magneson, Bolker, *and Continuity of Investment under I.R.C. Section 1031*, 20 U.S.F. L. REV. 177, 191 (1985) ("*Wagensen* thus teaches that the longer that one holds property following an exchange the greater the likelihood of establishing the requisite intent at the time of the exchange."); Paul Getty, *Holding Period Requirements in a 1031 Exchange - Not Just a Matter of Time, Intent is Key*, FGG1031 (Sept. 23, 2021), https://blog.fgg1031.com/blog/holding-period-requirements-in-a-1031-exchange ("In general, the longer a taxpayer holds property, the easier it will be to prove investment intent, but Courts have approved of exchanges when the relinquished property was held for only five days (*See* Allegheny Cnty. Auto Mart v. Comm'r 208 F2d 693, 1953 (3d Cir. 1953) [disallowing a loss deduction on reciprocal sale and purchase]) and when the replacement property was converted to personal use after only eight months [citing Reesink v. Comm'r, discussed *infra* text accompanying notes 169–170, 173]."); Andrew C., *1031 Exchanges: What Real Estate Investors Need to Know*, HACKYOURWEALTH (May 17, 2021), https://hackyourwealth.com/1031-exchange ("Of course, the

is a guidepost,[19] some commentators claim that holding exchange property until the subsequent tax year increases the likelihood that an exchange will satisfy the qualified-use requirement,[20] and, finally, some commentators, including the Author in prior articles and by way of the in-depth analysis in this Article, recognize there is no holding-period requirement.[21]

#### 2. *Talking Past Each Other Resulting from Authority Confusion*

Without effective transaction-classification, commentators appear to talk past each other. For instance, one commentator discussing the qualified-use requirement might consider authorities addressing exchanges and proximate business transactions and claim authoritatively that the qualified-use requirement does not impose a holding-period requirement.[22] Another commentator considering an authority that addresses an exchange and proximate general transaction might claim that a general transfer or conversion of the exchange property to a disqualified use immediately after an exchange disrupts the qualified-use requirement.[23] Alternatively, confusion and disagreement will result if commentators attempt to

longer you held title, the easier it is to prove that it was held for rental investment or business use. The shorter, the less easy it is to prove intent."); Michael M. Smith & Donald L. Ariail, *Like-Kind Exchanges of Partnership Properties*, THE TAX ADVISER (Dec. 1, 2008), https://www.thetaxadviser.com/issues/2008/dec/like-kindexchangesofpartnershipproperties.html ("[T]he partners and the partnership should allow for as much time as possible to pass between the dates of the exchange transaction and the distribution from, or contribution to, a partnership. At least one year should pass between the distribution and the initiation of the exchange with a qualified intermediary party and sale to the third-party purchaser. This suggestion is supported by the holdings in *Click* and *Wagensen*."). This conclusion is confusing because *Wagensen* granted section 1031 nonrecognition to an exchanger who held replacement property for approximately nine months before transferring it in the same year he acquired it. *See infra* notes 167–168, 171–172.

19. *See, e.g.*, *The 1031 Exchange Qualified Use Requirement and Importance of Intent—Is Time a Factor?*, FIRST AM. EXCH. CO., LLC, https://www.firstexchange.com/Holding-Period-Requirements-in-a-1031-Exchange-Not-Just-a-Matter-of-Time (last visited Feb. 26, 2024) ("Some tax advisors look to Private Letter Ruling ("P.L.R.") 8429039 (1984) as a guidepost, in which the IRS stated that a holding period of two years would be a 'sufficient' period of time for the property to be considered held for investment.").

20. *See, e.g.*, Getty, *supra* note 18 ("Some tax advisors believe that one year is also a sufficient holding period. First, if investment property is held for 12 months or more, the investor's tax returns will reflect this fact in two tax filing years. Second, in 1989, through HR 3150, congress had proposed that both the relinquished and replacement properties be held for one year to qualify for tax-deferred treatment."); David R. Chan, *Drop and Swap: Can You Relax if the Police Aren't Looking for You?*, TAX DEV. J. 1, 5 (2009) ("Of course getting a taxpayer to wait one or two years to complete the transaction may be impossible from a practical point of view, so if the taxpayer can be convinced to wait until the next taxable year to complete the transaction, many tax advisors would be pleased.").

21. *See* Bradley T. Borden, *Refuting the Notion of a General Holding Period Requirement for Section 1031*, PRAC. REAL EST. LAW. Nov. 2023, at 21; Bradley T. Borden, *Dialogue Debunking the Section 1031 Holding Period Myth*, TAX NOTES FED., Apr. 3, 2023, at 43; Andrew C., *supra* note 18 ("The tax code, the regulations, and the rulings have no holding period required.").

22. *See infra* Part III. (discussing exchanges and proximate business transactions).

23. *See infra* Part IV.B.1(b). (discussing exchanges and proximate business transactions that did not satisfy the qualified-use requirement).

amalgamate the various authorities and coalesce universal rules that apply to all qualified-use exchanges. This occurred in a publication by a qualified intermediary, which included six authorities addressing six different types of qualified-use exchanges in one paragraph of the publication.[24]

### B. Clarity from Transaction-Classification

Clarity regarding the qualified-use requirement emerges through transaction-classification and enumerating rules that apply to specific transactions. The various cases and rulings that consider the qualified-use requirement or rule with respect to qualified-use exchanges provide the basis for classifying qualified-use exchanges and the reasoning for the existence of specific rules for each of the different types of qualified-use exchanges.

The different types of qualified-use exchanges are diverse. For instance, exchanges and proximate business transactions raise the qualified-use requirement, as do exchanges by individuals transferring and acquiring single-family residences that are suitable for personal purposes. These two types of transactions are significantly different in both form and purpose. An exchange that occurs in proximity to a business transaction typically occurs in a bona fide business or investment environment, and one or more investors desire to continue to be invested in like-kind real property to be held for productive use in a trade or business or for investment before or after a business reorganization. In such situations, the continued-investment purposes of the nonrecognition provisions of section 1031 and the partnership tax rules work in tandem to allow for the tax-free transactions that facilitate the continued investment in property of a like-kind, with the possible mere change in the form of ownership.[25] On the other end of the spectrum, a property owner who is transferring property used for personal purposes or acquiring property to be used for personal purposes does not have the same

24. *The 1031 Exchange Qualified Use Requirement and Importance of Intent—Is Time a Factor?*, *supra* note 19 ("It should be noted that the IRS has issued certain rulings stating that if the property a taxpayer seeks to exchange was acquired immediately before the attempted exchange, the taxpayer will be viewed as having acquired that property primarily to resell for profit, not for investment or business use (see Revenue Rulings 84-121 [cooperative-buyer exchange, discussed *infra* Part IV.B.2(a)(2)], 77-337 [exchange after proximate business transactions, discussed *infra* text accompanying note 41], and 57-244 [circular exchange before sale, discussed *infra* text accompanying notes 174–176]). The IRS has also taken the position that if replacement property is disposed of immediately after the exchange, the property cannot be viewed as being held for a qualified use (see Revenue Ruling 75-292 [exchange before proximate business transaction, discussed *infra* text accompanying note 41]). However, the courts have been more taxpayer-friendly when evaluating whether the time held affects the taxpayer's intent to hold the property for investment or business use (see 124 Front Street Inc. v. Comm'r, 65 T.C. 6, 1975 [contracted-property exchange, discussed *infra* Part IV.B.2(a)(1)]). Yet in certain cases, the courts have agreed with the IRS's position on disqualifying an exchange when the replacement property is disposed of soon after its acquisition via exchange (*see* Black v. Commissioner., 35 T.C. 90, 1960 [disqualified use at time of acquisition, discussed *infra* 183–186]).") (citations in original).

25. *See infra* Part III.B.4.

continued-investment purpose. The rules that apply to these different types of transactions are understandably different.

To understand and provide advice with respect to the qualified-use requirement, advisors must be aware of the significant differences between the types of transactions that have raised the qualified-use requirement over time. Applying rules governing exchanges and proximate business transactions to exchanges and proximate personal transactions is just as inappropriate as applying principles of corporate taxation to a partnership or applying the rules governing involuntary conversions to section 1031 exchanges. The application of a law should be reserved for the facts for which the law was promulgated or for the issue it was designed to cover.

### C. TRANSACTION CLASSIFICATION & INTENT AT THE TIME OF EXCHANGE

To satisfy the qualified-use requirement, an exchanger must hold relinquished property and acquire replacement property to hold for productive use in a trade or business or for investment.[26] The intent of the exchanger at the time of the exchange ("intent-at-exchange principle") dictates whether the transaction satisfies the qualified-use requirement.[27] The inverse of the qualified-use requirement is that property held for personal use or primarily for sale does not satisfy the qualified-use requirement.[28] Thus, property held by the exchanger for personal use or primarily for sale at the time of an exchange will not satisfy the qualified-use requirement,[29] and property acquired to be held for personal use or primarily for sale will not satisfy the qualified-use requirement.[30]

The classification of a transaction determines the effort courts will expend to identify intent at the time of the exchange. As the discussion below illustrates, if the exchange occurs in proximity to a business transaction, in the absence of any evidence that would otherwise show the lack of the requisite intent, courts appear to find the presence of the requisite business-use or investment intent without additional inquiry. On the other hand, if the exchange occurs in proximity to a general transaction, courts may expend greater effort to determine intent at the time of the exchange.

Courts have made the application of the qualified-use requirement to exchanges and proximate business transactions *pro forma*. If property

26. I.R.C. § 1031(a)(1).

27. Magneson v. Comm'r, 753 F.2d 1490, 1493 (9th Cir. 1985) (citing Regals Realty Co. v. Comm'r, 127 F.2d 931, 933–34 (2d Cir. 1942), Click v. Comm'r 78 T.C. 225, 233–34 (1982)).

28. Starker v. Comm'r, 602 F.2d 1341, 1350 (9th Cir. 1979) ("use of property solely as a personal residence is antithetical to its being held for investment"); Moore v. Comm'r, 93 T.C.M. (CCH) 1275 (2007) (denying section 1031 nonrecognition to the disposition of property held exclusion for personal use).

29. *See infra* Part IV.B.2(b)(1).

30. *See infra* Part IV.B.1(b).

otherwise satisfies the qualified-use requirement[31]—an exchange that occurs prior to a tax-free contribution or tax-free distribution—satisfies the qualified-use requirement. Additionally, if property otherwise satisfies the qualified-use requirement[32]—an exchange that occurs after a tax-free contribution or tax-free distribution—satisfies the qualified-use requirement as a matter of law.[33]

With exchanges and proximate general transactions, the analysis of the qualified-use requirement is more complex and demands greater attention. For instance, if a person acquires a residence as part of a transaction intended to qualify for section 1031 nonrecognition and begins living in the residence, the question is whether the person intended the property for personal use when acquired.[34] To address this question, courts must engage in a deeper inquiry into the person's state of mind at the time of the exchange. The lack of technology to observe mental processes requires courts to consider available facts to assess the exchanger's state of mind at the time of an exchange. Not surprisingly, the law governing exchanges and proximate general transactions is not as crisp as the law governing exchanges and proximate business transactions.

The division of qualified-use exchanges into two broad categories of exchanges underscores this important distinction of both the categories of the transactions and the law that applies to each. The classification further allows advisors to follow the courts' method of applying relevant case law to specific exchanges.

### D. The Types of Qualified-Use Exchanges

Qualified-use exchanges come within two broad categories: (I) exchanges that occur in proximity to business transactions and (II) exchanges that occur in proximity to general transactions. Each broad category consists of groups, possibly subgroups, and types of qualified-use exchanges.

#### 1. *Exchanges & Proximate Business Transactions*

The category of exchanges and proximate business transactions can be divided into two groups with two types of qualified-use exchanges within each group: (A) exchanges that occur in proximity to contributions, including (1) exchanges before a contribution, (2) exchanges after a contribution; and (B) exchanges that occur in proximity to distributions, including (1) exchanges before a distribution and (2) exchanges after a distribution. The discussion below demonstrates that the courts hold that each type of

31. Property would not otherwise satisfy the qualified-use requirement if a partner used it for personal purposes before a contribution to a partnership or after a distribution from a partnership.

32. For instance, the exchanger would have to hold the acquired property for productive use in a trade or business or for investment for the exchange to satisfy the qualified-use requirement.

33. *See infra* Part III.E.

34. *See infra* Parts IV.B.1(a). and IV.B.1(b).

exchange in proximity to a business transaction satisfies the qualified-use requirement[35] unless the exchanger evidences a disqualifying intent to sell the property or convert it to personal use before or after a proximate business transaction or exchange.[36]

#### 2. *Exchanges & Proximate General Transactions*

Exchanges and proximate general transactions include both proximate purchases and sales and proximate purpose-conversions, so there are more types of transactions under this category of transactions. Purpose-conversions occur when a property owner's purpose for holding property changes. For instance, a property owner may acquire property for the purpose of developing and selling the property but change the purpose to investment, or a property owner may hold property for personal use and convert it to business-use property. Purpose-conversions and sales and purchases come within the same category because both constitute holding purposes that disqualify property from section 1031 nonrecognition.

Exchanges and proximate general transactions come within two groups: (A) exchanges before general transactions and (B) exchanges after the general transaction. The group of exchanges before general transactions includes two types of exchanges: (1) exchanges in which the exchanger changes intent following the transaction and (2) exchanges in which the exchanger has the prohibited intent at the time of the transaction. With exchanges before general transactions, the satisfaction of the qualified-use requirement turns upon whether the replacement property is acquired to be held for productive use in a trade or business or for investment.[37] Whether the subsequent transaction is a sale or a conversion does not appear to be decisive because either type of general transaction can cause the qualified-use requirement to fail. Consequently, separate subgroups of exchanges for sales and conversions are not needed for the group of exchanges before general transactions.

If the exchange occurs after a general transaction, the type of general transaction (conversion versus purchase) does appear to affect the potential legal outcome of the transaction, so separate groups are needed. The group of exchanges after general transactions includes two subgroups: (1) purchase transactions and (2) conversion transactions. The purchase subgroup includes two types of exchanges: (a) contracted-property exchanges and (b) cooperative-buyer exchanges. The purpose-conversion subgroup includes two types of exchanges: (a) exchanges in which the exchanger failed to convert the property to a qualified-use and (b) exchanges in which the exchanger successfully converted the property to a qualified-use.

35. *See infra* Part III.A.
36. *See infra* text accompanying note 95.
37. *See infra* Part IV.B.1.

### E. TAXONOMY OF QUALIFIED-USE EXCHANGES

The taxonomy of qualified-use exchanges is critical because it provides a structure for interpreting the law and applying it to the various transactions. The qualified-use exchanges are presented in their various categories in Figure 1.

<table>
<tr><th colspan="3">Figure 1:<br>Classification of Qualified-Use Exchanges</th></tr>
<tr><th colspan="3">Category I<br>Exchanges and Proximate Business Transactions</th></tr>
<tr><td>Group A<br>Exchanges Proximate to Contributions</td><td colspan="2">Group B<br>Exchanges Proximate to Distributions</td></tr>
<tr><td>Exchange Type 1<br>Exchanges before contributions</td><td colspan="2">Exchange Type 1<br>Exchanges before distributions</td></tr>
<tr><td>Exchange Type 2<br>Exchanges after contributions</td><td colspan="2">Exchange Type 2<br>Exchanges after distributions</td></tr>
<tr><td colspan="3"></td></tr>
<tr><th colspan="3">Category II<br>Exchanges and Proximate General Transactions</th></tr>
<tr><td>Group A<br>Exchanges Before General Transaction</td><td colspan="2">Group B<br>Exchanges After General Transaction</td></tr>
<tr><td>Exchange Type 1<br>Change of intent after exchange</td><td>Subgroup 1<br>Purchase Transactions</td><td>Subgroup 2<br>Conversion Transactions</td></tr>
<tr><td>Exchange Type 2<br>Disqualified intent at time of exchange</td><td>Exchange Type a<br>Contracted-Property</td><td>Exchange Type a<br>Failure to Convert</td></tr>
<tr><td></td><td>Exchange Type b<br>Cooperative-Buyer</td><td>Exchange Type b<br>Successful Conversion</td></tr>
</table>

## III. PROXIMATE TAX-FREE BUSINESS TRANSACTIONS

The law governing qualified-use exchanges that occur in proximity to business transactions is very clear. The following discussion presents the black-letter law that applies to exchanges and proximate business transactions and recounts the rationale for that law as expressed by the courts. The analysis then applies the tax-law analytical framework to show that the relevant authority is clear, longstanding, and has not been overruled or modified for decades. Any contrary authority that exists has been overruled or modified. Thus, the authority supporting the qualified-use requirement with respect to exchanges and proximate business transactions is very strong, and there is no contrary authority. Nonetheless, transactions that do not

comply with the rationale for the proximate-business-transaction rule do qualify for the application of the rule.

### A. THE LAW GOVERNING EXCHANGES IN PROXIMITY TO BUSINESS TRANSACTIONS

The Tax Court in *Bolker v. Commissioner* and *Maloney v. Commissioner* presents the qualified-use requirement as it relates to exchanges and proximate business transactions: "*A trade of property A for property B, both of like kind, may be preceded by a tax-free acquisition of property A at the front end, or succeeded by a tax-free transfer of property B at the back end*."[38] Subject to an exception,[39] this statement covers the field of exchanges and proximate business transactions, providing that they satisfy the qualified-use requirement. The statement from the Tax Court therefore should be read as black-letter law.

The Tax Court's statement of the law derives from a small number of precedential rulings that mostly cover the field of exchanges and proximate business transactions and provide the rationale for that rule. That law and the cases and rulings creating it have received extensive coverage in other publications,[40] so this Article summarizes those cases and rulings. The IRS, in the 1970s, took the position that an exchange before a tax-free contribution of property to a corporation and an exchange after a tax-free distribution from a corporation did not satisfy the qualified-use requirement.[41] In *Magneson v.*

38. Maloney v. Comm'r, 93 T.C. 89, 98 (1989) (emphasis added); Bolker v. Comm'r, 81 T.C. 782, 805 (1983), *aff'd* Bolker v. Comm'r, 760 F.2d 1039, 1045 (9th Cir. 1985).

39. *See infra* text accompanying note 95.

40. *See, e.g.*, Borden, *Dialogue Debunking the Section 1031 Holding Period Myth*, *supra* note 21; Bradley T. Borden, *Code Sec. 1031 Drop-and-Swaps Thirty Years After* Magneson, J. PASSTHROUGH ENT., Jan.–Feb. 2016, at 11 [hereinafter *Thirty Years After* Magneson]; Bradley T. Borden, *Code Sec. 1031 Drop-and-Swaps Thirty Years After* Bolker, J. PASSTHROUGH ENT., Sep.-Oct. 2015, at 21 [hereinafter *Thirty Years After* Bolker]; Bradley T. Borden, *Section 1031 and Proximate and Midstream Business Transactions*, 19 TAX MGMT. REAL EST. J. 307 (Nov. 2003).

41. Rev. Rul. 75-292, 1975-2 C.B. 333; Rev. Rul. 77-337, 1977-2 C.B. 305. In a private ruling, the IRS expressed a continued commitment to that position in the section 1033 context. I.R.S. Tech. Adv. Memo. 96-45-005 (July 23, 1996). In that ruling, a partnership owned land that it agreed to sell under threat of condemnation to a government authority. The partnership received nonrefundable deposits. The conveyance agreement provided that the partnership could distribute the property subject to the agreement. The day before closing, the partnership distributed a 50 percent interest in the property to each of the two partners pursuant to an assignment agreement signed by the partners and the partnership and recorded the deeds. The partners, lender, and partnership also executed an assumption agreement related to the loan on the property. The IRS cited several cases that considered who sold property in the corporate context. It then reasoned that the partnership, not the partners, was the seller of the property because (1) the timing of the transfer to the partners indicated that the distribution was to facilitate the use of the partners as conduits for the partnership to consummate the sale; (2) the distribution occurred after the timing and the actual date of closing was known; (3) the partition agreement prohibited partition of the property and prohibited the partners from taking any independent action with respect to the property; and (4) a requirement under the assumption agreement that the partners had to reconvey the property to the partnership if the property did not transfer to the authority by the latest possible closing date. The IRS found that the benefits and burdens did not pass to the partners and thus the substance of the

*Commissioner*[42] and *Bolker v. Commissioner*,[43] two cases decided by the Ninth Circuit in 1985, the court rejected those IRS rulings. In *Magneson*, the court reasoned that the contribution following the exchange was a change in the mechanism of ownership that did not significantly affect the amount of control or the nature of the underlying investment, so it did not preclude section 1031 nonrecognition.[44] In *Bolker*, the court held that the intent to exchange property after the distribution satisfies the qualified-use requirement because it is not the intent to liquidate the investment or use it for personal pursuits.[45]

Two Tax Court cases that followed on the heels of *Magneson* and *Bolker* show that the courts are not interested in nitpicking transactions to try to find distinguishing facts, such as holding period, that may lead to different results. *Maloney* was one of those cases; it considered an exchange by a corporation followed by the corporation distributing the replacement property.[46] The Tax Court in *Mason v. Commissioner* held that an exchange immediately following a distribution from a partnership satisfies the qualified-use

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transaction was the sale of the property by the partnership. With respect to section 1031 exchanges, courts have not taken such a hardline with respect to tax ownership and find tax ownership under very similar circumstances.

The IRS also ruled in the technical advice memorandum that the partners could not avail themselves of section 1033 nonrecognition even if the partnership had transferred tax ownership of the properties to the partners. The property would not satisfy the qualified-use requirement provided for in section 1033(g) because the partners received property from the partnership subject to the conveyance agreement. The IRS then cited *Barker v. United States*, 668 F. Supp. 1199 (C.D. Ill. 1987) and Rev. Rul. 84-121, 1984-2 C.B. 168 as authority that the partners could not satisfy the qualified-use requirement. As discussed below, however, that case and ruling apply to cooperative-buyer exchanges. *See infra* Part IV.B.2(a)(2). With the transaction at issue in the technical advice memorandum, the partners did not acquire property at the direction of the seller to facilitate the seller's exchange. Thus, the IRS incorrectly applied *Barker* and Rev. Rul. 84-121. The relevant authority related to the qualified-use requirement would be *124 Front Street v. Commissioner*, 65 T.C. 6 (1975), *discussed infra* at text accompanying notes 209–211, because the partner acquired the property under contract to sell it, so the transaction was a contracted-property exchange. *See infra* Part IV.B.2(a)(1). Because the technical advice memorandum addresses section 1033, instead of section 1031, the relevance of the ruling is questionable with respect to section 1031 exchanges. The IRS also distinguished the facts under consideration from the facts in *Bolker* because the property was under contract when received by the partner. The Tax Court would not consider that distinction to be relevant. *See, e.g.*, Mason v. Comm'r, 55 T.C.M. (CCH) 1134 (1988); Maloney v. Comm'r, 93 T.C. 89, 98 (1989); Bolker v. Comm'r, 81 T.C. 782, 805 (1983), *aff'd* Bolker v. Comm'r, 760 F.2d 1039, 1045 (9th Cir. 1985).

42. Magneson v. Comm'r, 753 F.2d 1490 (9th Cir. 1985).

43. *Bolker*, 760 F.2d at 1039.

44. *Magneson*, 753 F.2d at 1497.

45. *Bolker*, 760 F.2d at 1045.

46. *Maloney*, 93 T.C. at 93; *see also* I.R.S. Priv. Ltr. Rul. 2006-51-030 (Sept. 19, 2006) (granting section 1031 nonrecognition to an exchange that occurred immediately before a trust was scheduled to terminate and transfer replacement property to a limited liability company); I.R.S. Priv. Ltr. Rul. 2005-21-002 (Feb. 24, 2005) (granting section 1031 nonrecognition to an exchange that occurred prior to the terminating distribution of replacement property from a testamentary trust); I.R.S. Priv. Ltr. Rul. 81-26-070 (Mar. 31, 1981).

requirement.[47] In *Mason*, the transaction was a separation of ownership of multiple properties held in multiple partnerships by the same two owners who were each taking sole ownership of properties as part of the separation.[48] The parties apparently agreed to such a transaction, but the facts do not clearly establish that the transaction was documented in that manner.[49] Nonetheless, the Tax Court found that exchanges of the distributed property occurred between individuals following the apparent distribution of the properties from the partnerships.[50]

The *Mason* ruling demonstrates that courts are loath to recast transactions to disallow gain recognition on a series of transactions that each qualify for nonrecognition. In *Magneson*, the Ninth Circuit stated, "[b]etween two equally direct ways of achieving the same result, [taxpayers are] free to choose the method which entail[s] the most advantages to them."[51] Courts are therefore wont to find that exchanges in proximity to business transactions satisfy the qualified-use requirement.

The Department of Justice relied upon the ruling in *Bolker* to argue for section 1031 nonrecognition in *Barker*.[52] Thus, although the IRS has not specifically acquiesced to *Bolker*, the federal government's reliance on it in another case indicates that the IRS may accept the *Bolker* decision and rationale. Indeed, by relying on *Bolker*, which took a position contrary to the IRS's position in Rev. Rul. 77-337 (a distribution from a corporation followed by an exchange), the federal government appears to have implicitly overruled Rev. Rul. 77-337, confirming that Rev. Rul. 77-337 is no longer good authority.[53]

### B. RATIONALE FOR TAXPAYER-FAVORABLE RULINGS

Exchanges and proximate business transactions are types of nonrecognition transactions, and the purposes for which Congress grants nonrecognition to both types of transactions overlap significantly. Those overlapping purposes provide the basis for courts ruling that exchanges that occur in proximity to business transactions satisfy the qualified-use requirement.

47. Mason v. Comm'r, 55 T.C.M. (CCH) 1134 (1988).

48. *Id.*

49. *Id.*

50. *Id.*

51. Magneson v. Comm'r, 753 F.2d 1490, 1497 (9th Cir. 1985).

52. Barker v. United States, 668 F. Supp. 1199, 1202 (C.D. Ill. 1987) ("Further, the [government] asserts that the *Bolker* court concluded that since the taxpayer purchased the property with the intent to exchange it in a like kind exchange, it was held for 'productive use in trade or business or for investment,' because it was not intended that the property be used for personal pursuits."). The exchanger in *Barker* wanted to recognize gain to increase the amount of investment tax credit for which the exchanger could qualify. *Id.* at 1201. Thus, the U.S. government was arguing for the transaction to qualify for section 1031 nonrecognition based upon *Bolker*.

53. *See* Treas. Reg. § 1.6662-4(d)(3)(iii); *supra* text accompanying note 41 (discussing Rev. Rul. 77-337, 1977-2 C.B. 305).

### 1. *Purpose for Section 1031 Nonrecognition*

Congress enacted the original version of section 1031 for three purposes: (1) to make the law accurate and certain;[54] (2) to promote exchanges of property and relieve them from delay;[55] and (3) to exempt from taxation transactions in which investors remain invested in the same kind of property.[56] Courts recognize that section 1031 grants nonrecognition because an exchanger remains invested in substantially similar property, the exchanger's investment is unliquidated, and the exchanger's economic position does not materially change as a result of an exchange.[57] Taxing like-kind exchanges would have a chilling effect on real estate transactions and violate fundamental principles of equity.[58] Thus, as the *Bolker* court

54. H.R. REP. NO. 67-350, at 10 (1921), *reprinted in* 1939-1 (pt. 2) C.B. 168, 175-76.; *see also* S. REP. NO. 67-275, at 11 (1921), *reprinted in* 1939-1 (pt. 2) C.B. 181, 188-89 ("[N]o part of the present income-tax law has been productive of so much uncertainty and litigation or has more seriously interfered with those business readjustments which are peculiarly necessary under existing conditions." Congress believed that by excepting like-kind exchanges from gain and loss recognition it would be "removing a source of grave uncertainty [and would] permit business to go forward with the readjustments required by existing conditions."). *See also* Bradley T. Borden, *The Section 1031 Exchange Requirement*, 18 BROOK. J. CORP. FIN. & COM. L. 407 (2024) [hereinafter Borden, *Exchange Requirement*].

55. 61 CONG. REC. 5201 (1921).

56. H.R. REP. NO. 73-704, at 13 (1934), *reprinted in* 1939-1 (part 2) C.B. 554, 564 ("The law has provided for 12 years that gain or loss is recognized on exchanges of property having a fair market value, such as stocks, bonds, and negotiable instruments; on exchanges of property held primarily for sale; or on exchanges of one kind of property for another kind of property; but not on other exchanges of property solely for property of like kind. In other words, profit or loss is recognized in the case of exchanges of notes or securities, which are essentially like money; or in the case of stock in trade; or in case the taxpayer exchanges the property comprising his original investment for a different kind of property; but if the taxpayer's money is still tied up in the same kind of property as that in which it was originally invested, he is not allowed to compute and deduct his theoretical loss on the exchange, nor is he charged with a tax upon his theoretical profit. The calculation of the profit or loss is deferred until it is realized in cash, marketable securities, or other property not of the same kind having a fair market value.").

57. Comm'r v. P.G. Lake, Inc., 356 U.S. 260, 268 (1958) ("'[T]he underlying assumption of [section 1031(a)] is that the new property is substantially a continuation of the old investment still unliquidated.'" (citing Treas. Reg. § 39.112(a)-1 (1953))); Jordan Marsh Co. v. Comm'r, 269 F.2d 453, 456 (2d Cir. 1959) ("These passages lead us to accept as correct the petitioner's position with respect to the purposes of the section. Congress 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. If such gains were not to be recognized, however, upon the ground that they were theoretical, neither should equally theoretical losses. And as to both gains and losses the taxpayer should not have it within his power to avoid the operation of the section by stipulating for the addition of cash, or boot, to the property received in exchange."); Estate of Bartell v. Comm'r, 147 T.C. 140, 161 (2016) ("The purpose for the foregoing deferral has been identified in jurisprudence involving section 1031 and its predecessor statutes as resting on the lack of any material change in the taxpayer's economic position"); Koch v. Comm'r, 71 T.C. 54, 63 (1978) ("The basic reason for allowing nonrecognition of gain or loss on the exchange of like-kind property is that the taxpayer's economic situation after the exchange is fundamentally the same as it was before the transaction occurred.").

58. *See Jordan Marsh Co.*, 269 F.2d at 456 (observing 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

articulated, an exchanger satisfies the qualified-use requirement "by lack of intent either to liquidate the investment or to use it for personal pursuits."[59]

### 2. *Purpose for Business-Transaction Nonrecognition*

The partnership tax contribution and distribution rules[60] and corporate reorganization nonrecognition rules[61] have similar purposes for granting nonrecognition to certain business transactions that occur for business reasons and are continuations of ownership in modified form.[62] A leading commentator on partnership tax observed that Congress

> decided to adhere to this rule, whether the exchange be regarded as an exchange of interests in property or as an exchange of properties for a "partnership interest." It was felt that to tax the transaction would tend to discourage the formation of partnerships and operate as a deterrent to new business enterprises.[63]

Thus, the "policy of non-recognition of gain (and, of course, loss) is based primarily on a desire not to discourage the formation of partnerships and is continued by Section 721 of the new law."[64] Such a purpose applies

the same sort."); Bradley T. Borden, *The Like-Kind Exchange Equity Conundrum*, 60 FLA. L. REV. 643, 662 (2008) ("The primary justification for section 1031 lies in continuity of investment, and equity supports continuity of investment"); 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."); 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 of section 1031's continued-investment purpose. . . . 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. To maintain the equitable positions of two such similarly situated taxpayers, section 1031 provides that the exchanger who acquires like-kind property does not recognize gain or loss on the exchange. 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.").

59. Bolker v. Comm'r, 760 F.2d 1039, 1045 (9th Cir. 1985).

60. *See* I.R.C. §§ 721, 731.

61. *See* I.R.C. §§ 354, 355, 361. Contributions of property to corporations can be tax-free if the contributor is part of the control group following the contribution. *See id.* § 351.

62. Treas. Reg. §§ 1.368-1(b), (d)(2), -2(g); Rev. Rul. 70-18, 1970-1 C.B. 74 (providing that nonrecognition is granted to corporate reorganizations that "are required by business exigencies and which affect only a readjustment of continuing interest in property under modified corporate forms"); *Id.* ("Section 355 of the Code contemplates a continuity of the entire business enterprise under modified corporate forms and a continuity of interest in all or part of such business enterprise on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the distribution.").

63. J. Paul Jackson et al., *A Proposed Revision of the Federal Income Tax Treatment of Partnerships and Partners—American Law Institute Draft*, 9 TAX L. REV. 109, 120 (1954) (footnotes omitted), *cited in* Bradley T. Borden, *Aggregate-Plus Theory of Partnership Taxation*, 43 GA. L. REV. 717, 764 (2009).

64. J. Paul. Jackson et al., *The Internal Revenue Code of 1954: Partnerships*, 54 COLUM. L. REV. 1183, 1204 (1954).

equally to tax-free distributions from partnerships. This stated purpose for granting tax-free contributions to and distributions from partnerships echoes the purpose of section 1031 to not interfere with transactions and to promote exchanges.

#### 3. *Continuation of Investment is the Defining Feature*

The defining feature of nonrecognition business transactions and exchanges is that they change the form of ownership but neither start nor terminate ownership in property. This is particularly the case for closely held businesses.[65] This feature distinguishes exchanges and proximate business transactions from exchanges and proximate general transactions and explains why the courts treat the two categories of exchanges differently.

A contribution of property to a partnership or corporation does not terminate the contributor's ownership in the property but merely transforms the ownership from direct to indirect ownership. Similarly, the distribution of property from a partnership does not start or terminate the distributee's ownership in the property; it merely transforms it. This concept of continued ownership is important because if courts find continued ownership, they do not deem the transaction to be a liquidation of the investment or change of holding intent. Thus, the finding of a proximate business transaction (in the absence of a clear change of intent in proximity to the transactions) allows the courts to find, as a matter of law, that the requisite intent for the qualified-use requirement has been satisfied.

#### 4. *Courts Recognize & Rely Upon Overlapping Nonrecognition Purposes*

Courts explicitly recognize that the nonrecognition purposes of section 1031 and the business transactions rules overlap and grant nonrecognition to exchanges that occur in proximity to business transactions because the nonrecognition rules apply to both transactions. To illustrate, the court in *Magneson* stated:

> The central purpose of both sections 721 and 1031(a), as stated by the Treasury Regulations, is to provide for nonrecognition of gain on a transfer of property in which the differences between the property parted with and the property acquired "are more formal than substantial," and "the new property is substantially a continuation of the old investment still unliquidated."[66]

The court also stated:

65. *See, e.g.*, United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 454–55 (1950) ("[T]he distinction [between owners acting on their own behalf and the owners acting on behalf of the corporation] may be particularly shadowy and artificial when the corporation is closely held.").

66. Magneson v. Comm'r, 753 F.2d 1490, 1494 (9th Cir. 1985) (citing Treas. Reg. 1.1002-1(c)).

> The case law, the regulations, and the legislative history are thus all in agreement that the basic reason for nonrecognition of gain or loss on transfers of property under sections 1031 and 721 is that the taxpayer's economic situation after the transfer is fundamentally the same as it was before the transfer: his money is still tied up in investment in the same kind of property.[67]

The court viewed the transfer of property to or from a partnership as mere changes in the form of ownership, not a cashing out or change to personal use:

> This principle exactly describes the Magnesons' situation. Before the two transactions, their investment was a fee interest in income-producing real estate. They exchanged this property for other income-producing real estate, which they held as tenants in common with NER. The Magnesons and NER then changed the form of their ownership of that real estate from tenancy in common to partnership. They still own the income-producing real estate, and they have taken no cash or non-like-kind property out of the transaction. The Magnesons' transactions therefore fit squarely within the central purpose of section 1031. They exchanged their investment property for like-kind investment property which they continued to hold for investment, albeit in a different form of ownership.[68]

The court also provided that "[s]o long as, as in this case, the taxpayers continue to hold it for investment, a change in the mechanism of ownership which does not significantly affect the amount of control or nature of the underlying investment does not preclude nonrecognition under section 1031(a)."[69] "Finally, we note that a critical basis for our decision is that the partnership in this case had as its underlying assets property of like kind to the Magnesons' original property, and its purpose was to hold that property for investment."[70] This treatise-like explanation from the *Magneson* court demonstrates the courts take into account that the purposes of section 1031 and the partnership tax rules overlap and complement each other.

In *Bolker*, the Tax Court also recognized overlapping complementary purposes of section 1031 and the corporate liquidation rules that, at the time, allowed for tax-free liquidating distributions of corporations (similar to the current partnership tax rules).[71] The court stated,

> In short, where a taxpayer surrenders stock in his corporation for real estate owned by the corporation, he continues to have an economic interest in essentially the same investment, although there has been a change in the form of ownership. His basis in the real estate acquired on liquidation is equal to his basis in the stock surrendered, and the gain realized is not

67. *Id.*
68. *Id.* at 1494–95.
69. *Id.* at 1497.
70. *Id.* at 1498.
71. Bolker v. Comm'r, 81 T.C. 782, 805 (1983).

> recognized but deferred until gain on the continuing investment is realized through a liquidating distribution. At that point, proceeds of the sale are taxed to the extent of the gain.[72]

The court also reiterated the purpose for allowing tax-free transfers to and from entities: "[s]ection 333 recognizes the taxpayer's continuing investment in the real estate without the interposition of a corporate form."[73] *Bolker* and *Magneson* illustrate that courts look through the corporate or partnership form and deem the shareholder or partner to own an entity's property in a form that differs from direct ownership. The courts do not consider the form of the entity relevant to the analysis.

The court in *Maloney* (an exchange by a corporation followed by a distribution of the exchange property) found that the exchange reflected "both continuity of ownership and of investment intent."[74] After the exchange and liquidation, the exchanger "continued to have an economic interest in essentially the same investment, although there was a change in the form of the ownership."[75] Finally, the court ruled that "the mere addition of another nontaxable transaction (at least, a transaction exempted by section 721 or 333) does not automatically destroy the nontaxable status of the transaction under section 1031."[76]

The Tax Court in *Magneson v. Commissioner* recognized that a contribution to a tax partnership "is a nontaxable transaction under section 721 which, together with section 1031(a), is unequivocally described above in [Treas. Reg. § 1.1002-1], as representing a continuation of the old investment unliquidated."[77] The regulations list section 1031 and the tax-free contribution provisions (sections 351(a) and 721) and describe the nonrecognition purpose of these sections as follows (the Tax Court has applied similar reasoning to tax-free distribution provisions[78]):

> These sections describe certain specific exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences are more formal

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72. *Id.*

73. *Id.* The version of section 333 that the court considered in *Bolker* has been repealed, so a liquidating distribution to the sole member of a corporation no longer qualifies for section 1031 nonrecognition. I.R.C. § 311(b).

74. Maloney v. Comm'r, 93 T.C. 89, 99 (1989).

75. *Id.*

76. *Id.*

77. Magneson v. Comm'r, 81 T.C. 767, 771–73 (1983) (listing the following as factors that show that a contribution is a change in form but not a liquidation of the investment: (1) there is no recapture; (2) the basis of the contributed property is the same as the basis the contributing member had in the property; and (3) the partnership's holding period tacks on to the contributing member's holding period).

78. The Tax Court in *Bolker* and *Mason* apply the same principles to tax-free distribution provisions. *Bolker*, 81 T.C. 805 ("Section 333 recognizes the taxpayer's continuing investment in real estate without the interposition of a corporate form"); Mason v. Comm'r, 55 T.C.M. (CCH) 1134 (1988) ("Sections 731 and 1031(a) . . . govern the transaction").

> than substantial. As to these, the Code provides that such differences shall not be deemed controlling, and that gain or loss shall not be recognized at the time of the exchange. The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated.[79]

The courts and the IRS clearly understand the overlapping purposes of section 1031 nonrecognition and the nonrecognition rules governing business transactions and relying upon those purposes in granting nonrecognition to exchanges that occur in proximity to business transactions. The courts thus reach their conclusions by cogently relating the applicable law to pertinent facts.[80]

### C. SUPPORTING & CONTRARY AUTHORITY

Despite the overwhelming persuasiveness of authority that has granted section 1031 nonrecognition to exchanges in proximity to business transactions, commentators and advisors continue to express concern about transfers occurring immediately before or after an exchange.[81] The analysis that follows focuses on weighting the authority that addresses the exchanges and proximate business transactions and demonstrates the weight of authority for nonrecognition is very strong. Figure 2 presents the types of exchanges and proximate business transactions. The table presents contributions and distributions on the x-axis and the ordering of the exchange with respect to the contribution and distribution on the y-axis. All exchanges and proximate business transactions should fit on this table. The table identifies relevant authority (i.e., authority that has considered the tax treatment of exchanges that occur in proximity to business transactions) that addresses each type of exchange. The table uses the terms "supporting authority" to identify authority that concluded the exchanges qualified for section 1031 nonrecognition and "contrary authority" to identify authority that concluded the exchanges did not qualify for section 1031 nonrecognition.

79. Treas. Reg. § 1.1002-1(c).

80. *See* Treas. Reg. § 1.6662-4(d)(3)(ii) (discussing the persuasiveness of an authority); Borden, *Tax-Law Analysis*, *supra* note 14, at 392.

81. The Author continues to encounter such thinking in private conversations with section 1031 advisors. *See also supra* notes 17–20.

| **Figure 2: Exchanges and Proximate Business Transactions Supporting and Contrary Authority** | | |
|---|---|---|
| | **Contribution** | **Distribution** |
| **After Exchange** | Supporting authority: *Magneson, Maloney*<br>Contrary authority: *Regals Realty Co.*, Rev. Rul. 75-292 | Supporting authority: *Maloney, Magneson*<br>Contrary authority: Rev. Rul. 75-292 |
| **Before Exchange** | Supporting authority: *Bolker, Maloney, Mason,*<br>Contrary authority: Rev. Rul. 77-337 | Supporting authority: *Bolker, Mason, Maloney*<br>Contrary authority: Rev. Rul. 77-337 |

The table gives relevance to authority that considers similar ordering of transactions even if the type of business transaction differs. For instance, the transaction in *Magneson* is an exchange followed by a contribution to a partnership, but the table identifies it as supporting authority for an exchange followed by a distribution. The courts that have considered exchanges and proximate business transactions specifically and explicitly cite to the overlapping nonrecognition purposes of section 1031 and the business transaction rules.[82] None of the cases or rulings that consider exchanges and proximate general transactions will have comparable relevance, so they will have little, if any, weight in the analysis. The analysis follows the lead of those courts and gives relevance to cases that consider transactions that qualify for both types of nonrecognition provisions. The focus now turns to weighting the authority that is relevant to each type of exchange and proximate business transaction.

### D. Weighting Proximate-Business-Transaction Authority

The three tools that determine the weight of authority provide the framework for weighting (this verb is appropriate in this context because the analysis determines the weight of the various authorities) the authority that considers exchanges and proximate business transactions.[83] In line with fundamental tax-law analysis,[84] the weighting process relies upon the relevance, persuasiveness, and type of document for each authority. Because the authorities identified in Figure 3 have facts in common with the four types of exchanges and proximate business transactions, they will have stronger relevance than the cases and rulings discussed below that have materially distinguishable facts.[85]

82. *See supra* Part III.B.4.
83. *See* Borden, *Tax-Law Analysis*, *supra* note 14, at 391–400 (discussing the three tools for determining the weight of authority).
84. *See id.*
85. Treas. Reg. § 1.6662-4(d)(3)(iii); *infra* Part IV. (discussing exchanges and proximate general transactions).

Figure 3 lists authority that considers the tax treatment of an exchange that occurs in proximity to a business transaction. Under each authority, it identifies the type of exchange that occurs in proximity to a business transaction and then considers the strength of each of the weighting factors as applicable to the authority. For the test of relevance, the more closely the pertinent facts in the case relate to the described transaction, the stronger the relevance score. For the test of persuasiveness, the more cogent the application of law to the facts in the case, the stronger the persuasiveness score. For the type of document, the circuit court opinions score the strongest, while the Tax Court opinions score very strong but not as high as the circuit court opinions because circuit courts can overrule or modify a Tax Court opinion.

Regarding the revenue rulings, they appear to be relevant because they consider exchanges that occur in proximity to business transactions.[86] The rulings are conclusory and lack significant analysis,[87] so they receive weak scores for persuasiveness. The type-of-document score for the revenue rulings is extremely low because they have been overruled by the Ninth Circuit. Thus, to the extent the revenue rulings continue to be a type of authority, they are extremely weak.

**Figure 3:**
**Weight of Authority Addressing Exchanges and Proximate Business Transactions**

| Transaction | Relevance | Persuasive-ness | Type of Document | Weight of Authority |
|---|---|---|---|---|
| ***Magneson v. Commissioner* (1985)** | | | | |
| Exchange before contribution | Common facts: exchange immediately before contribution. Distinguished facts: case considered contribution by general partner. Highly relevant. | Cogent application of law to facts: investment continued in a different form. Highly persuasive. | Ninth Circuit Court of Appeals. In force for almost 40 years. Followed and cited by other courts. Highly authoritative. | Extremely strong supporting authority for exchange followed by contribution. Entity type not central to decision. |

86. The Ninth Circuit in *Bolker* appeared to distinguish the facts in *Bolker* from Rev. Rul. 77-337, 1977-2 C.B. 305, by claiming the exchanger in Rev. Rul. 77-337 did not receive the exchange property from the corporation before transferring it. Bolker v. Comm'r, 760 F.2d 1039, 1043 (9th Cir. 1985) ("A never held the [relinquished property], and therefore section 1031(a) did not apply."). That position was not central to the holding in *Bolker*, and observers consider the exchanger to have received the exchange property from the corporation before the exchange. *See, e.g.*, Borden, *Exchange Requirement*, *supra* note 54, at 455–58.

87. *Bolker*, 760 F.2d at 1043 ("Neither ruling cites case authority for its holdings.").

**Figure 3:**
**Weight of Authority Addressing Exchanges and Proximate Business Transactions**

| Transaction | Relevance | Persuasiveness | Type of Document | Weight of Authority |
|---|---|---|---|---|
| ***Regals Realty Co. v. Commissioner* (1942)** | | | | |
| Exchange before contribution | Common facts: exchange before next-year contribution to a corporation. Distinguished facts: immediately after exchange, and before contribution, board resolved to sell replacement property and shareholders approved resolution. Only relevant if decision to sell precedes contribution. Not relevant to most exchanges followed by contribution. | Cogent application of law to facts. Highly persuasive. | Second Circuit Court of Appeals. In force more than 80 years. Court relied upon Tax Court's[88] finding that the exchanger did not intend to hold the property for investment. Distinguished by *Bolker* and *Maloney*. The Tax Court has since, in *Maloney*, confirmed that a tax-free transfer of property after an exchange does not, by itself, disrupt the qualified-use requirement. Highly authoritative. | Very weak contrary authority if no resolution to sell property prior to contribution. Very strong contrary authority if facts indicate an intent to sell immediately after acquisition and prior to contribution. |

88. The decision was by the Board of Tax Appeals, the predecessor to the Tax Court. HAROLD DUBROFF & BRANT J. HELLWIG, THE UNITED STATES TAX COURT: AN HISTORICAL ANALYSIS, 175–228 (2d ed. 2014).

**Figure 3:**
**Weight of Authority Addressing Exchanges and Proximate Business Transactions**

| Transaction | Relevance | Persuasive-ness | Type of Document | Weight of Authority |
|---|---|---|---|---|
| ***Bolker v. Commissioner*** **(1985)** | | | | |
| Distribution before exchange | Common facts: distribution before exchange. Distinguished facts: exchange decided after distribution. Highly relevant. | Cogent application of law to facts: an exchange that is neither a cashing out of investment nor conversion to personal use, satisfies the qualified-use requirement. Highly persuasive. | Ninth Circuit Court of Appeals. In force for almost 40 years. Followed and cited by other courts. Highly authoritative. | Extremely strong supporting authority for acquisition of property with intent to exchange for property to be held for productive use in a trade or business or for investment. |
| Contribution before exchange. | Common facts: exchange after tax-free business transaction. Distinguished facts: contribution, not distribution. Type of business transactions is not material because nonrecognition purpose is similar. Very relevant. | Facts not under consideration, but court stated that an exchange after a tax-free business transaction qualifies. Very persuasive. | Ninth Circuit Court of Appeals. In force for almost 40 years. Followed and cited by other courts. Highly authoritative. | Very strong supporting authority for exchange after tax-free contribution. |
| ***Maloney v. Commissioner*** **(1989)** | | | | |
| Exchange before distribution | Common facts: exchange before tax-free distribution. Highly relevant. | Cogent application of law to facts: accounted for purpose of section 1031 and tax-free | Tax Court opinion. In force for almost 35 years. The ruling is precedent and should be | Extremely strong supporting authority for exchange before distribution. |

| **Figure 3: Weight of Authority Addressing Exchanges and Proximate Business Transactions** | | | | |
|---|---|---|---|---|
| **Transaction** | **Relevance** | **Persuasive-ness** | **Type of Document** | **Weight of Authority** |
| | | distribution rules. Relied upon *Magneson* and *Bolker*. Highly persuasive. | binding on the Tax Court for any case with applicable facts. Statement of law: exchange can occur before or after tax-free business transaction. Very authoritative. | Very strong supporting authority for exchange before or after a tax-free business transaction. |
| Exchange before contribution | Common facts: exchange before tax-free business transaction. Distinguished facts: business transaction was a contribution, not a distribution. Difference is not material because the contributions and distributions change form of ownership. Highly relevant. | Cogent application of law to facts: accounted for purpose of section 1031 and tax-free business transaction rules. Relied upon *Magneson* and *Bolker*. Highly persuasive. | Tax Court opinion. In force for almost 35 years. The ruling is precedent and should be binding on the Tax Court for any case with applicable facts. Statement of law: exchange can occur before or after tax-free business transaction. Very authoritative. | Extremely strong supporting authority for exchange before distribution. Very strong supporting authority for exchange before or after a tax-free business transaction. |
| Exchange after contribution or distribution | Common facts: exchange in proximity to tax-free business transaction. | Facts not under consideration, but the court stated that an exchange | Tax Court opinion. In force for almost 35 years. The ruling is | Very strong supporting authority for exchange after tax-free contribution. |

**Figure 3:**
**Weight of Authority Addressing Exchanges and Proximate Business Transactions**

| Transaction | Relevance | Persuasive-ness | Type of Document | Weight of Authority |
|---|---|---|---|---|
| | Distinguished facts: business transaction occurs before the exchange. Based upon the court's statement of law, distinguished facts are immaterial. Very relevant. | after a tax-free business transaction qualifies. Very persuasive. | precedent and should be binding on the Tax Court for any case with applicable facts. Statement of law: exchange can occur before or after tax-free business transaction. Very authoritative. | |
| ***Mason v. Commissioner* (1988)** | | | | |
| Distribution before exchange | Common facts: exchange arranged prior to distribution. Exchange immediately after distribution. Highly relevant. | Cogent application of law to facts: considered structure of transaction. Highly persuasive. | Tax Court memorandum opinion. In force for 35 years. Tax Court memorandum opinions have less weight than general Tax Court opinion. Very authoritative. | Strong supporting authority for exchange after distribution. |
| **Rev. Rul. 75-292** | | | | |
| Exchange before contribution | Common facts: *Magneson* court distinguished facts, finding that the purported exchanger may not become the tax owner of the purported | Conclusory Not persuasive. | Ninth Circuit in *Magneson* and Tax Court in *Maloney* have implicitly or explicitly overruled the IRS with respect to the ruling | Not authority. Either overruled or distinguished by the Ninth Circuit |

| **Figure 3: Weight of Authority Addressing Exchanges and Proximate Business Transactions** | | | | |
|---|---|---|---|---|
| **Transaction** | **Relevance** | **Persuasive-ness** | **Type of Document** | **Weight of Authority** |
| | exchange property prior to contribution.[89] Otherwise facts are similar. Relevant or not relevant. | | regarding the qualified-use requirement. Courts are not bound by revenue rulings. Not authority to very weak authority. | |
| | | **Rev. Rul. 77-337** | | |
| Distribution before exchange | Common facts: *Bolker* court distinguished facts, finding that the purported exchanger may not have become the tax owner of the exchange property prior to transfer.[90] Otherwise, facts are similar. Relevant to not relevant. | Conclusory Not persuasive. | Ninth Circuit in *Bolker* and the Tax Court in *Mason* have implicitly or explicitly overruled the IRS with respect to the ruling regarding the qualified-use requirement. Courts are not bound by revenue rulings. *Maloney* statement of law applies. The U.S. government relied upon *Bolker* in other cases, implicitly overruling | Not authority. Either overruled or distinguished by Ninth Circuit, Tax Court, and IRS |

89. Magneson v. Comm'r, 753 F.2d 1490, 1493 (9th Cir. 1985) ("Revenue rulings, however, are not binding on this court. . . . More significantly, transfer to a corporation in exchange for shares is distinguishable from transfer to a partnership for a general partnership interest . . . .").

90. *Bolker*, 760 F.2d at 1044 ("In sum, the Commissioner is supported by two revenue rulings which are neither controlling nor precisely on point.").

| **Figure 3: Weight of Authority Addressing Exchanges and Proximate Business Transactions** | | | | |
|---|---|---|---|---|
| **Transaction** | **Relevance** | **Persuasive-ness** | **Type of Document** | **Weight of Authority** |
| | | | Rev. Rul. 77-337.[91] Not authority to weak authority. | |

This analysis and presentation of relevant authority establish that the support is very strong for reporting section 1031 nonrecognition for exchanges that occur in proximity to business transactions.

### E. INTENT ESTABLISHED AS A MATTER OF LAW

In both *Bolker* and *Magneson*, the Ninth Circuit recognized that intent is determined at the time of exchange,[92] but it held that the exchanges qualified for section 1031 nonrecognition, i.e., had the requisite intent at the time of the exchange.[93] These holdings and the holdings in *Maloney* and *Mason*,[94]

91. *See* Borden, *Tax-Law Analysis*, *supra* note 14, at 392–95.

92. *Bolker*, 760 F.2d at 1043 ("The rule of those cases . . . is that at the time of the exchange the taxpayer must intend to keep the property acquired, and intend to do so with an investment purpose."); *Magneson*, 753 F.2d at 1493 ("Numerous cases have held that the taxpayers' intent at the time of the exchange to liquidate their interest in the property acquired disqualifies the exchange from nonrecognition under section 1031(a)."); *see supra* text accompanying notes 42–45 (discussing *Bolker* and *Magneson*).

93. *Bolker*, 760 F.2d at 1045 ("the intent to exchange property for like-kind property satisfies the holding requirement, because it is not an intent to liquidate the investment or to use it for personal pursuits."); *Magneson*, 753 F.2d at 1492 ("We are faced in this ease with an issue of first impression in the Courts of Appeals: whether property acquired in a like-kind exchange with the intention of contributing it to a partnership under Internal Revenue Code § 721 is 'held' for investment within the meaning of Internal Revenue Code § 1031(a)."), 1493 ("Therefore, the Magnesons' exchange can only qualify under section 1031(a) if contributing property to a partnership in return for an interest in the partnership is 'holding' the property for investment within the meaning of section 1031(a)"), 1495 ("The Magnesons' transactions therefore fit squarely within the central purpose of section 1031. They exchanged their investment property for like-kind investment property which they continue to hold for investment, albeit in a different from of ownership."), 1496 ("If at the time of the exchange, as here, the taxpayer intends to contribute the property to a partnership for a general partnership interest, and the partnership's purpose is to hold the property for investment, the holding requirement of section 1031(a) is satisfied.").

94. Maloney v. Comm'r, 93 T.C. 93, 99 (1989) ("The exchanger before us reflects both continuity of ownership and of investment intent."); Mason v. Comm'r, 55 T.C.M. (CCH) 1134 (1988) ("[W]e believe that the parties intended to exchange their interests in property . . . . [Exchangers] exchanged their interests in certain assets, primarily real estate, in a like-kind exchange. Section 1031 provides for nonrecognition of gain or loss on an exchange of property held for productive use in a trade or business or investment solely for property of 'like kind' which is to be held for productive use in a trade or business or for investment."); *see supra* text accompanying notes 46–50 (discussing *Maloney* and *Mason*).

suggest that an exchanger satisfies the requisite intent as a matter of law in an exchange in proximity to a business transaction.

*Regals Realty* presents an exception to that general rule of law,[95] allowing for the possibility that an exchange or contribution or distribution may be the backup plan that results when a plan by the exchanger to liquidate or convert property does not materialize. The two-fold factual inquiry therefore becomes:

1. Did the exchanger acquire property in an exchange or tax-free contribution or distribution, and did the exchanger then transfer property in an exchange or tax-free contribution or distribution? and
2. Did the exchanger have any intent to liquidate the investment or convert the property to a disqualified use between acquisition and subsequent tax-free transfer?

If the answer to the first question is "yes" and the answer to the second is "no," as a matter of law, the exchanger satisfies the qualified-use requirement. If the answer to the second question is "yes," then the qualified-use requirement is not established as a matter of law.

If the form of the transaction is a tax-free distribution or contribution followed by an exchange or an exchange followed by a tax-free contribution or distribution, the exchanger should be able to establish that the requisite transactions have occurred.[96] If an exchanger can establish that the transaction is an exchange in proximity to a business transaction with no interim intent to liquidate the investment or convert it to a disqualified use, the exchange should satisfy the qualified-use requirement as a matter of law. This conclusion is consistent with the Tax Court's statement of the law in *Maloney*: "A trade of *property A* for *property B*, both of like kind, may be preceded by a tax-free acquisition of *property A* at the front end, or succeeded by a tax-free transfer of *property B* at the back end."[97] The law established in

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95. Regals Realty Co. v. Comm'r, 127 F.2d 931, 934 (2d. Cir. 1942) (ruling that the corporation's resolution and efforts to the sell replacement property prior to contributing it to another corporation "was substantial evidence to sustain the . . . finding that the taxpayer did not establish that [the relinquished property] was exchanged for property 'to be held . . . for investment.'"); *see infra* text accompanying note 182 (discussing *Regals Realty* as an exchange in proximity to a general transaction because the exchanger acquired the replacement property with the intent to sell it).

96. *See* Borden, *Exchange Requirement*, *supra* note 54, at 437–42 (establishing that courts respect the form of transactions in considering whether a transaction satisfies the section 1031 exchange requirement).

97. *Maloney*, 93 T.C. at 98; *see supra* text accompanying note 38. This rule of law only applies to exchanges that precede or follow a tax-free contribution of property to or distribution from an entity. Other proximate business transactions, such as midstream restructurings, implicate the exchange requirement, not the qualified-use requirement. *See* BORDEN, *supra* note 2, at ¶ 7.1[2]. As a general rule, corporate transactions to which section 481 attribute carryover applies apparently can be undertaken while an exchange is pending without disrupting the application of section 1031 to the exchange. *Id.* at ¶ 7.6[1]. On the other hand, other midstream corporate transactions and many

the authority that considers exchanges and proximate business transactions shows that a separate finding of intent at the time of exchange is not required with such transactions (unless there is evidence of intent to liquidate the investment or convert it to a disqualified use between transactions[98]). The law does not require the exchanger to hold exchange property for a period before or after the proximate business transaction to satisfy the qualified-use requirement. In fact, holding property for a period of time between the exchange and proximate business transaction could create room for the court to consider whether the exchanger had an intent during that period to liquidate the investment or convert it to a disqualified use. Thus, holding property for a period of time between an exchange and proximate business transaction creates a risk of failing the qualified-use requirement; it does not reduce the risk of such a failure, but absent any evidence of change of intent, such a change of intent would not exist.

The authority discussed to this point considers a single exchange occurring before a single linear business transaction. The authority appears to consider other linear transactions that result in a continuation of an investment. For instance, distributions up tiered partnerships or contributions down through tiered partnerships should not affect the general application of authority addressing exchanges and proximate business transactions. Even if property moves through various tiers, the exchanger would remain invested in property with a mere change in form. If the movement of property becomes circular, however, the exchanger may sever the continued investment, and the transaction could become a disguised sale.

### F. *CRENSHAW* & THE DISGUISED-SALE CAVEAT

If an exchanger engages in a circular series of transactions, the rules that generally apply to exchanges and proximate business transactions may become inapplicable. For instance, in *Crenshaw v. United States*,[99] the exchanger, a member of a partnership, received an offer from a potential purchaser to acquire the exchanger's interest in the partnership.[100] The exchanger's attorney advised her that she would obtain more favorable tax treatment if she were to exchange her interest in the partnership's property rather than sell the partnership interest.[101] The attorney and exchanger then devised the following structure to attempt an exchange: (1) the partnership distributed an undivided interest in its property to the exchanger in

midstream partnership restructurings would disrupt an intended section 1031 exchange. *Id.* at ¶¶ 7.2[3], 7.3[3], 7.6[2][b], 7.6[2][c], 7.7[1].

98. *Regals Realty Co.*, 127 F.2d 931 (disallowing section 1031 nonrecognition to an exchange because the exchanger showed evidence of intent to sell the replacement property following acquisition).

99. Crenshaw v. United States, 450 F.2d 472 (5th Cir. 1971).

100. *Id.* at 474.

101. *Id.*

liquidation of her interest in the partnership; (2) the exchanger transferred the undivided interest to the estate of her late husband, the estate of which she was executrix, in exchange for property held by the estate; (3) the estate then sold the undivided interest to the buyer; and (4) the buyer transferred the undivided interest back to the partnership in exchange for the partnership interest formerly owned by the exchanger.[102] The record showed that the first three transactions occurred on the same day, November 30, 1962, and the final transaction occurred no later than January 31, 1963, the final day of the partnership's fiscal year.[103]

The Fifth Circuit applied the step transaction doctrine; ignored the distribution, exchange, and contribution; and ruled that the transaction was a sale of partnership interest and there was no exchange.[104] The court focused particularly on the last transaction, the transfer by the purchaser of the interest back to the partnership.[105] The court noticed that the transaction would not have been equivalent to a sale of an interest in the partnership if the undivided interest in the property had not found its way back to the partnership.[106] If the purchaser had not transferred the undivided interest back to the partnership, the exchanger's interest in the partnership would have been liquidated, and the "complete obliteration" of her interest in the partnership could not have been characterized as a sale.[107] Because the buyer paid money and ended up with an interest in the partnership, it received exactly what it would have received by way of a direct purchase of the partnership interest from the exchanger.[108] The last step was essential to the transaction because, without it, the buyer would not have been interested.[109] The buyer was willing to cooperate with the exchanger's transaction only if the transaction ended with the buyer owning the exchanger's interest in the partnership.[110] The property got back to the partnership "exactly as it all began," and the exchanger's interest was then owned by the buyer.[111]

The transaction occurred in 1962 (and may have extended to 1963), before the 1989 enactment of section 1031(f),[112] the related-party exchange rules. If the *Crenshaw* distribution and exchange had been respected by the court after the enactment of section 1031(f), section 1031(f) most likely would have denied nonrecognition of the exchange.[113] The beneficiary and

102. *Id.*
103. *Id.* at 474 n.3.
104. *Id.* at 475–77.
105. *Id.* at 477.
106. *Id.*
107. *Id.*
108. *Id.*
109. *Id.*
110. *Id.*
111. *Id.*
112. Pub. L. No. 101-239, § 7601(a), 103 Stat. 2106, 2370 (1989)
113. Several authorities have denied section 1031 nonrecognition to exchanges in which the exchanger acquired replacement property from a related party. *See, e.g.*, N. Cent. Rental & Leasing,

executor of an estate are related for purposes of section 1031(f).[114] Consequently, if the exchanger was a beneficiary of her husband's estate, the exchange would have been between her as the beneficiary and her as the executrix. Because the exchanger was willing to sell the undivided interest from the estate for cash, the property the estate held presumably had a stepped-up basis from the death of the exchanger's husband that transferred to the undivided interest upon exchange.[115] Section 1031(f) was enacted to prevent such basis shifting and cashing out,[116] so, if that exchange had been respected, under current law, it would not have qualified for section 1031 nonrecognition. The court's ruling is more far-reaching as it encompasses exchanges and proximate business transactions that are actually disguised sales of partnership interests. *Crenshaw* should apply to any transaction that is a distribution from an entity, followed by an exchange by the distributee partner for property that may be acquired from a third party, and a contribution of the distributed property by the purchaser back to the distributor partnership. Such transactions result in the purchaser owning the partnership interest that the distributee partner held prior to the distribution. The circular movement of the property to and from the same entity distinguishes *Crenshaw* from other authorities that consider exchanges and proximate business transactions.

#### 1. *Linear Versus Circular Movement of Property*

The movement of the property in *Crenshaw* was circular—the property moved from the partnership to the partner, to the buyer, and back to the partnership. Contrast that with the linear movement of property in the exchanges and proximate business transactions that qualified for section 1031 nonrecognition. With the latter transactions, the property either moved (a) from an entity to the exchanger and then into the exchange or (b) to an exchanger and then into or out of an entity. The distributed property did not

LLC v. United States, 779 F.3d 738 (8th Cir. 2015); Ocmulgee Fields, Inc. v. Comm'r, 613 F.3d 1360 (11th Cir. 2010); Teruya Bros., Ltd. v. Comm'r, 580 F.3d 1038 (9th Cir. 2009); Rev. Rul. 2002-83, 2002-2 C.B. 927; I.R.S. Tech. Adv. Memo. 97-48-006 (Aug. 25, 1997); Bradley T. Borden, *North Central and the Expansion of Code Sec. 1031(f) Related-Party Exchange Rules*, J. PASSTHROUGH ENT., May–June 2015, at 25, 27.

114. I.R.C. §§ 267(b)(13), 1031(f)(3).

115. I.R.C. §§ 1014(a)(1) (providing that the basis of property acquired from a decedent shall be the fair market value of that property), 1031(d) (providing that basis of property received in a section 1031 exchange shall be the basis of the transferred property).

116. *See* H.R. REP. NO. 101-247 at 1340 (1989) ("Because a like-kind exchange results in the substitution of the basis of the exchanged property for the property received, related parties have engaged in like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low-basis property in order to reduce or avoid the recognition of gain on the subsequent sale. . . . The committee believes that if a related-party exchange is followed shortly thereafter by a disposition of the property, the related parties have, in effect, 'cashed out' of the investment, and the original exchange should not be accorded nonrecognition treatment."); Alton et al., *supra* note 58, at 473–74.

return to its starting point. The movement of the property was therefore linear, not circular. That distinction is important because it makes *Crenshaw* irrelevant to the typical exchange and proximate business transaction, and it makes the authority that considers the typical exchange and proximate business transaction irrelevant to transactions that are disguised sales of partnership interests.

#### 2. *Continued Investment versus Disrupted Ownership*

The juxtaposition of *Crenshaw* against the exchanges and proximate business transactions emphasizes the continued-investment justification for granting section 1031 nonrecognition to exchanges that occur in proximity to most business transactions. In each of the exchanges that occurred in proximity to a business transaction that was granted nonrecognition, the form of ownership changed, but the owner did not change. For instance, the transfer of property to or from a partnership changes the form of ownership from partner-owned to partnership-owned. In *Crenshaw*, the partnership's ownership of the property began as partnership-owned and ended as partnership-owned by the same partnership. Although the exchanger was able to continue an investment in a modified form in like-kind property by disregarding the distribution of the interest from the partnership to the partner, the *Crenshaw* court was unable to establish the requisite link between the partner's ownership interest in the partnership assets and its ownership interest in the new property. Thus, courts look at whether the exchanger continues an investment in property, what happens to the exchanger's previous investment in the partnership, and how the transaction unfolded. If the exchanger is merely replaced as a member of a partnership, the exchanger may be deemed to have sold an interest in the partnership and would lose the benefit of section 1031 in such a transaction.

#### 3. *The* Crenshaw *Weight of Authority*

*Crenshaw* is very strong contrary authority for disguised sale transactions. If the facts of a situation are that property leaves a partnership and circles from the distributee partner to a buyer and then back to the distributing partnership, *Crenshaw*'s relevance is very strong. The court in *Crenshaw* cogently applied the law to the facts, so the decision is highly persuasive. Finally, *Crenshaw* was decided by the Fifth Circuit more than 50 years ago and has not been overruled, so it is a highly authoritative type of document. Consequently, *Crenshaw* is very strong contrary authority for circular-movement exchanges.

*Crenshaw* is not, however, strong contrary authority for a linear exchange and proximate business transaction for multiple reasons. First, because the facts of *Crenshaw* are distinguished from the facts of the authorities that consider linear exchanges and proximate business

transactions, *Crenshaw* is not relevant to such transactions. Second, because the *Crenshaw* court ruled that the exchanger did not become the tax owner of the property for which it received legal title, it did not consider the qualified-use requirement. Consequently, *Crenshaw* is very weak authority or is simply not authoritative regarding the qualified-use requirement with respect to linear exchanges and proximate business transactions. Exchangers and their advisors must remember that an exchange in proximity to a business transaction must also satisfy the other section 1031 requirements, including the exchange requirement and real property requirement.

### G. TAX OWNERSHIP & REAL-PROPERTY REQUIREMENTS REMAIN IMPORTANT

*Crenshaw* is a reminder that although the qualified-use requirement is satisfied as a matter of law with exchanges and proximate business transactions, such transactions may nonetheless fail to qualify for section 1031 nonrecognition because they fail one of the other requirements. This Article recognizes that the transaction must also satisfy the exchange requirement and the real-property requirement, while other works examine those requirements in detail.[117]

#### 1. *The Exchange Requirement*

As described through in-depth analysis elsewhere,[118] when considering the exchange requirement, courts follow the form of the transaction unless the substance of the transaction belies the form.[119] *Crenshaw* and *Chase* (discussed below) are extreme examples of transactions in which the substance of the transaction was obvious (or the form was indefinite), so the courts relied upon the substance as the basis of their rulings. Even though *Chase* and *Crenshaw* are rare section 1031 cases that find the exchange requirement failed, they are instructive.

The Tax Court in *Chase v. Commissioner* found that tax ownership of the property did not transfer to the distributee member.[120] There, the partnership received an offer to purchase the property on January 20, 1980 (the first offer), and the taxpayer caused the partnership to deed a tenancy-in-common interest in the partnership's property to allow the taxpayer to complete an

117. *See, e.g.*, Borden, *Exchange Requirement*, *supra* note 54; Borden, *TICnerships*, *supra* note 6.

118. *See* Borden, *Exchange Requirement*, *supra* note 54, at 421–46.

119. *See, e.g.*, Barker v. Comm'r, 74 T.C. 555, 561, 565 (1980) ("Yet, if the exchange requirement is to have any significance at all, the perhaps formalistic difference between the two types of transactions must, at least on occasion, engender different results." "To the complaint that this treatment places undue emphasis on a formalistic step of no substance, we repeat what we have already said: that the conceptual distinction between an exchange qualifying for section 1031 on the one hand and a sale and reinvestment on the other is largely one of form.")

120. Chase v. Comm'r, 92 T.C. 874, 882 (1989).

exchange.[121] That first offer expired, and the property did not transfer to that potential buyer, but the partnership received a second offer on March 21, 1980.[122] The negotiations with the buyer occurred at the partner level, with no mention that the taxpayer held title.[123] The taxpayer recorded the January 20 deed from the partnership on June 12, 1980, for the taxpayer's 46.3527-percent undivided interest in the property.[124]

The taxpayer entered into an exchange agreement and directed their share of the sale proceeds to be deposited in trust to be used to acquire replacement property.[125] Upon closing of the sale, the closing agent transferred 41 percent of the proceeds to a trust established to receive the taxpayer's share of the net sale proceeds.[126] That 41 percent represented the taxpayer's distributed share of the partnership's net proceeds, not the 46.3527-percent share related to the taxpayer's claimed undivided interest in the property.[127] From the January 20 date until the date the property transferred, the partnership continued to pay all expenses related to the property and received all of the revenue, and the taxpayer's relationship with respect to the property did not change after the deed was transferred.[128]

The Tax Court claimed to apply the substance-over-form doctrine and held that, in substance, the partnership disposed of the property.[129] The court based its decision upon the following findings of fact: (1) the partnership and the taxpayers continued treating the partnership as the owner of the property for accounting and distribution purposes; (2) the sales proceeds were apportioned based upon the partnership agreement, not the co-ownership of property; and (3) none of the other partners approved the distribution of an undivided interest to the taxpayers.[130] The court then found that because the partnership transferred property and the taxpayers acquired property, there was no reciprocal transfer of property, and the transaction could not satisfy the exchange requirement.[131] Because the parties did not treat the ownership as transferring from the partnership to the partner, the court found that tax ownership had not transferred to the partner, and it therefore held that the transaction was not an exchange for section 1031 purposes. Exchangers can avoid the facts in *Chase* by ensuring that their treatment of the transaction follows the form of the transaction and ensuring that the parties are aware of intended transfers. They should be able to establish the requisite intent with

121. *Id.* at 876.
122. *Id.* at 877.
123. *Id.*
124. *Id.*
125. *Id.* at 877–78.
126. *Id.* at 878 (providing that the taxpayer received $3,799,653 of $9,210,876 net proceeds).
127. *Id.*
128. *Id.* at 878–79.
129. *Id.* at 883.
130. *Id.* at 881–82.
131. *Id.* at 883.

distribution and redemption agreements signed by the parties needed to approve such transactions.

The Ninth Circuit in *Bolker* distinguished Rev. Rul. 75-292 and Rev. Rul. 77-337 (which denied section 1031 nonrecognition[132]) from the facts of *Bolker*, noting that the exchanger in those rulings may not have held—i.e., become the tax owner of—the exchange property.[133] That position contradicts the position the Ninth Circuit took in *Magneson*, in which the court recognized that the exchanger in Rev. Rul. 75-292 received and contributed property to a corporation.[134] The *Magneson* position is consistent with the body of law governing the exchange requirement.[135] The *Bolker* and *Magneson* court's observation about the exchanger becoming the tax owner of property in the revenue rulings was incidental to the court's ruling.[136] In those rulings and the other rulings governing exchanges in proximity to business transactions, courts grant section 1031 treatment even if the exchanger's ownership of exchange property is transitory.[137] This is consistent with the general body of law governing the exchange requirement.[138] Thus, exchangers can satisfy the exchange requirement when an exchange occurs in proximity to a business transaction, even if the exchanger acquires and transfers property simultaneously.

### 2. *The Real-Property Requirement*

The interest acquired by the exchanger must be real property, and it cannot be an interest in an arrangement that federal income tax law treats as a partnership.[139] This requirement is particularly important if the property acquired is an undivided interest in real property because if co-ownership arrangements are properly structured, they can be partnerships for federal income tax purposes.[140] Indeed, establishing ownership through deeds in real

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132. *See supra* text accompanying note 41.

133. Bolker v. Comm'r, 760 F.2d 1039, 1043 (regarding Rev. Rul. 77-337, 1977-2 C.B. 305, the Ninth Circuit stated, "[the exchanger] never held the shopping center, and therefore section 1031(a) did not apply'" and regarding Rev. Rul. 77-297, the Ninth Circuit stated, "as to the [exchanger, the exchange] does not [qualify for section 1031 nonrecognition], since [the exchanger] never held [the relinquished property] and acquired it solely to exchange").

134. Magneson v. Comm'r, 753 F.2d 1490, 1493 (9th Cir. 1985).

135. The Ninth Circuit's observation in *Bolker* that the exchanger did not hold the property is a significant misstatement of the authority governing the exchange requirement. In numerous cases, courts and the IRS have ruled that exchangers or exchange partners become the tax owner of property even though the ownership is transitory. *See* Borden, *Exchange Requirement*, *supra* note 54, at 421–65.

136. In both cases, the court stated that it was not bound by revenue rulings. *Bolker*, 760 F.2d at 1043; *Magneson*, 753 F.2d at 1493.

137. *See supra* text accompanying notes 46–50.

138. *See* Borden, *Exchange Requirement*, *supra* note 54, at 413–47.

139. Treas. Reg. § 1.1031(a)-3(a)(5)(i)(C) (providing that interests in a partnership are not real property for purposes of section 1031).

140. Numerous judicial decisions find that co-ownership arrangements are tax partnerships for tax purposes. *See, e.g.*, Cusick v. Comm'r, 76 T.C.M. (CCH) 241 (1998); Bergford v. Comm'r, 12

property does not necessarily guarantee that an arrangement will not be treated as a partnership for federal income tax purposes.[141] Nonetheless, most practitioners believe that if a co-ownership arrangement complies with most of the conditions in Rev. Proc. 2002-22, the arrangement will not be a tax partnership.[142] With many exchanges that occur in proximity to business transactions, the exchanger's ownership of the property is transitory, meaning the exchanger acquires property and simultaneously transfers it or transfers it shortly after acquisition.[143]

One concern about an exchanger's ownership of an undivided interest in real property being transitory is that the exchanger may not be able to establish that the arrangement satisfies the conditions in Rev. Proc. 2002-22 or has any of the attributes of a tenancy-in-common.[144] Nonetheless, the courts do not appear concerned with that and have not expressed concern that the undivided interest could be a tax partnership.[145] The courts' lack of concern that such arrangements could be tax partnerships is reasonable because a tax partnership is a business, financial operation, or venture that is carried on by the participants.[146] If an arrangement is ephemeral and

F.3d 166 (9th Cir. 1993); Alhouse v. Comm'r, 62 T.C.M. (CCH) 1678 (1991); Marinos v. Comm'r, 58 T.C.M. (CCH) 97 (1989); Cokes v. Comm'r, 91 T.C. 222 (1988); Bussing v. Comm'r, 89 T.C. 1050 (1987); Bussing v. Comm'r, 88 T.C. 449 (1987); Press v. Comm'r, 52 T.C.M. (CCH) 285 (1986); Underwriters Ins. Agency of Am. v. Comm'r, 40 T.C.M. (CCH) 5 (1980); Madison Gas and Elec. Co. v. Comm'r, 633 F.2d 512 (7th Cir. 1980); Estate of Levine v. Comm'r, 72 T.C. 780 (1979); McManus v. Comm'r, 583 F.2d 443 (9th Cir. 1978); Demirjian v. Comm'r, 457 F.2d 1 (3d Cir. 1972); Podell v. Comm'r, 55 T.C. 429 (1970); Rothenberg v. Comm'r, 48 T.C. 369 (1967); Luckey v. Comm'r, 334 F.2d 719 (9th Cir. 1964); United States v. U.S. Nat'l Bank of Portland, 239 F.2d 475 (9th Cir. 1956); Bentex Oil Corp. v. Comm'r, 20 T.C. 565 (1953); Est. of Langer v. Comm'r, 16 T.C. 41 (1951); Tompkins v. Comm'r, 97 F.2d 396 (4th Cir. 1938); Winmill v. Comm'r, 93 F.2d 494 (2d Cir. 1937); Reynolds v. McMurray, 60 F.2d 843 (10th Cir. 1932); I.T. 2749, XIII-1 C.B. 99 (1934); I.T. 2081, 111-3 C.B. 176 (1924); I.T. 1604, 11-1 C.B. 1 (1923); I.R.S. Priv. Ltr. Rul. 83-150-03 (June 17, 1982); *see also* Borden, *TICnerships*, *supra* note 6, at 651–77 (discussing issues that arise from exchanging interests in co-ownership arrangements that might be classified as interests in a partnership for federal income tax purposes).

141. Borden, *TICnerships*, *supra* note 6, at 614–15.

142. Rev. Proc. 2002-22, 2002-1 C.B. 733; Borden, *TICnerships*, *supra note* 6, at 612–13; Bradley T. Borden & Todd D. Keator, *Tax Opinions in TIC Offerings and Reverse TIC Exchanges*, TAX MGT. REAL EST. J., Mar. 7, 2007, at 88.

143. *See, e.g.*, Bolker v. Comm'r, 760 F.2d. 1039, 1041, 1045 (ruling that the exchanger was the tax owner of property transferred three months after acquisition with a plan to transfer it at time of acquisition); Magneson v. Comm'r, 753 F.2d 1490, 1492, 1498 (ruling that the exchanger was the tax owner of an undivided interest in property transferred on the day of acquisition); Maloney v. Comm'r, 93 T.C. 89, 93 (1989) (ruling that the exchanger was the tax owner of property acquired and transferred within one month after acquisition with a plan to transfer it made within a few days after acquisition); Mason v. Comm'r, 55 T.C.M (CCH) 1134. (1988) (ruling that the exchanger was the tax owner of an undivided interest in property transferred at the time of acquisition).

144. *See* Borden, *Thirty Years After* Bolker, *supra* note 40, at 28 ("If a tax partnership distributes undivided interests in property to its members, tax law could treat their ownership as a tax partnership if the former members, as co-owners of the property, conduct a sufficient level of business activity.").

145. *See, e.g.*, *Magneson*, 753 F.2d at 1498; *Mason*, 55 T.C.M (CCH) 1134.

146. I.R.C. § 761; Treas. Reg. § 301-7701-1(a)(2).

disappears as soon as it forms, it cannot carry on a trade or business during that instance it existed. Courts appear to be unconcerned about an undivided interest being an interest in a partnership if the exchanger owns the interest momentarily.[147] To help ensure that the transitory arrangement is not a tax partnership, advisors will often advise their clients to enter into a tenancy-in-common agreement that complies with Rev. Proc. 2002-22 for the instant the client will hold the undivided interest.[148] Because form is critical with such transactions, showing the arrangement is a tenancy-in-common in form should be helpful.

### H. LIMIT OF THE RULE APPLICABLE TO EXCHANGES IN PROXIMITY TO BUSINESS TRANSACTIONS

As a general rule, an exchange in proximity to a business transaction will satisfy the qualified-use requirement.[149] This rule can only be applied, however, to entities that hold like-kind property for productive use in a trade or business or for investment. The *Magneson* court stated:

> [W]e will examine the purpose and underlying assets of the partnership acquired to determine if the Magnesons have a continuing investment in like-kind property. The property the Magnesons contributed to the partnership was, of course, of like-kind to their original property. The rest of the partnership property was also like-kind, and the partnership's purpose was to hold real estate investment property, the kind of property that the Magnesons initially owned. Therefore, the Magnesons' ten-percent partnership interest in the underlying assets was entirely in like-kind property to their original investment, and the transaction qualifies under section 1031(a). In contrast, if the Magnesons had made the same initial exchange for like-kind real estate, but had contributed the real estate to a partnership that did not hold it for investment, or that did not have as the predominant part of its assets other like-kind real estate, the exchange would not qualify under section 1031(a). This would be so because once the Magnesons contributed their property, the underlying assets of their investment are the other assets of the partnership, and if those assets are not of like kind to the Magnesons' original real estate investment, the Magnesons have not continued their investment in like-kind property. Our holding in this case is limited to those situations in which the taxpayer exchanges property for like-kind property with the intent of contributing the acquired property to a partnership for a general partnership interest. Further, the taxpayer must show, as the Magnesons have here, that the purpose of the partnership is to hold the property for investment, and that the total

147. *See, e.g.*, *Magneson*, 753 F.2d at 1498; *Mason*, 55 T.C.M (CCH) 1134.

148. Even though Rev. Proc. 2002-22, 2002-1 C.B. 733 lists ruling guidelines, practitioners believe that the IRS will not challenge the classification of an arrangement as a tenancy-in-common arrangement if it satisfies the pre-ruling conditions in Rev. Proc. 2002-22. *See, e.g.*, Borden & Keator, *supra* note 142.

149. *See supra* Part III.A.

assets of the partnership are predominantly of like kind to the taxpayer's original investment."[150]

The discussion of the qualified-use requirement as it relates to exchanges and proximate business transactions therefore only applies to entities that have a predominant part of their assets in real property that is of a like-kind to the exchanger's other exchange property. Nonetheless, the limitation does not appear to apply only to partnerships that have single assets. For instance, in *Mason*, partners owned multiple properties indirectly through two partnerships.[151] The two partnerships liquidated and distributed undivided interests in the properties to the partners, who then exchanged those undivided interests in such a manner that each partner ended up being the sole owner of some of the properties.[152] The IRS has privately stated that the division of "jointly-owned property is not a sale or other disposition, but merely a severance of joint ownership."[153] Thus, an exchange of a single real property distributed from a partnership owning multiple real properties and the exchanger's contribution of a replacement property to a partnership with multiple real properties should not disqualify the exchange from section 1031 nonrecognition. The focus in *Magneson* appears to be on whether the assets of the entity are primarily real estate.[154]

## IV. PROXIMATE GENERAL TRANSACTIONS

The authorities that consider the qualified-use requirement for exchanges that occur in proximity to general transactions are quite different from the authorities considered above. General transactions include transfers of property from a buyer or seller or conversions of property from one use to another, e.g., the conversion of investment property to personal-use property. Such general transactions, unlike business transactions, do not include transfers to or from separate entities. After explaining the fundamental differences between business transactions and general transactions, this Article examines authorities that consider exchanges that occur prior to proximate general transactions and then examines authorities that consider exchanges following proximate general transactions.

### A. GENERAL TRANSACTIONS AS GENESIS & TERMINUS EVENTS

General transactions differ from business transactions in a very fundamental way: a general transaction either starts ownership or business-

150. *Magneson*, 753 F.2d at 1498.

151. *Mason*, 55 T.C.M (CCH) 1134; *see supra* text accompanying notes 47–50 (discussion *Mason*).

152. *Mason*, 55 T.C.M (CCH) 1134.

153. I.R.S. Priv. Ltr. Rul. 2003-03-023 (Jan. 17, 2003), (citing Noble v. Beach, 130 P.2d 426, 430 (Cal. 1942) to support claim that property owners do not acquire a new or additional interest upon partition).

154. *See supra* text accompanying note 150.

use or investment in property (the genesis of ownership or qualified purpose) or terminates ownership or business-use or investment in property (terminus of ownership or qualified purpose). By contrast, business transactions merely alter the form of ownership of property, so the owner continues the investment in similar property in a modified form after a business transaction.[155] The continuation of the investment in modified form and the overlapping purposes of section 1031 nonrecognition and the entity nonrecognition rules provide support for granting section 1031 nonrecognition to exchanges and nonrecognition for the proximate business transaction.[156] Because general transactions are genesis or terminus events, the purposes for granting nonrecognition to exchanges that occur in proximity to business transactions do not apply to exchanges that occur in proximity to general transactions. That fundamental distinction is critical to remember when considering the relevance of the authorities that consider the different categories of transactions.

When considering an exchange in proximity to a business transaction, courts find, as a matter of law, that the exchanger has the requisite intent.[157] Other than with respect to one narrow exception,[158] courts cannot establish the requisite qualified-use intent, as a matter of law, with respect to exchanges that occur in proximity to general transactions. Consequently, the courts generally must expend greater effort to identify the intent of the exchangers and draw from surrounding facts to help determine that intent when they consider exchanges that occur in proximity to general transactions. Nonetheless, the categorization of exchanges that occur in proximity to general transactions determines the authorities that are most relevant to particular transactions and indicates how courts are most likely to rule with respect to typical fact patterns.

#### 1. *Relevance is the Key Factor*

Several authorities, mostly case law, consider whether an exchange in proximity to a general transaction satisfies the qualified-use requirement. The discussion that follows shows that most of the authorities provide that the exchange did not satisfy the qualified-use requirement, but several cases rule that the exchange did satisfy the qualified-use requirement. The sheer number of authorities that are favorable to section 1031 nonrecognition compared to those that are unfavorable does not inform the analysis. Instead, the specific facts of each authority and the type of exchange to which it applies are the most important factors in determining the outcome of the qualified-use question.

155. *See supra* Part III.B.2.
156. *See supra* Part III.B.4.
157. *See supra* Part III.E.
158. *See infra* Part IV.B.2(a)(1).

The effect relevance has on a case's weight of authority can be illustrated with a few examples. First, if the facts show that the exchanger intended to convert the property to personal use at the time of exchange, the cases with similar facts present strong contrary authority, and the exchange most likely would not qualify for section 1031 nonrecognition.[159] Second, if the facts show that an exchanger acquired replacement property with the intent to hold it but changed that intent subsequently because of some intervening event, such as a change in financial condition or inability to rent the property, the cases with similar facts present strong authority, and the exchanger should satisfy the qualified-use requirement.[160] Third, if an exchanger is under contract to acquire property to hold for investment or business use, and a third party offers to purchase the property from the exchanger, the transaction would appear to be a contracted-property transaction, and the case law with similar facts provide strong authority that the exchange satisfies the qualified-use requirement.[161] Fourth, if an interested purchaser agrees to purchase property, at the seller's direction, to facilitate the seller's exchange, the transaction looks like a cooperative-buyer exchange, and the buyer's exchange would not satisfy the qualified-use requirement.[162] Finally, if an exchanger has treated property as inventory or personal-use property up to the point of transfer, an exchange of that property would not appear to satisfy the qualified-use requirement.[163]

The careful analysis of each qualified-use authority shows that, with each transaction, the holding period is far less relevant than the other facts. In fact, the most important factor is the type of transaction. Once the relevance is determined, the outcome can be predicted. Because the authorities are not contradictory with respect to exchanges and proximate general transactions, the type of document becomes unimportant. Each case has sufficiently cogent application of law to facts to satisfy the persuasiveness prong of the weighting analysis, so relevance is paramount to determining the strength of authority supporting or contrary to the qualified-use requirement in each type of transaction.

#### 2. *Intent at Time of Exchange is Paramount*

With few exceptions,[164] the cases that consider whether the qualified-use requirement is satisfied in exchanges that occur in proximity to general transactions focus on facts that indicate the exchanger's intent at the time of

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159. *See infra* Part IV.B.1(b).
160. *See infra* Part IV.B.1(a).
161. *See infra* Part IV.B.2(a)(1).
162. *See infra* Part IV.B.2(a)(2).
163. *See infra* Part IV.B.2(b)(1).
164. *See infra* Part IV.B.2(a)(1).

the exchange.[165] The courts look to facts to determine that intent and could rule on a case-by-case basis, but the existing authority provides insight into how courts determine the intent and the types of facts that signal the existence or absence of that intent. The case law provides fairly clear lines for predicting the tax outcome of many types of qualified-use exchanges.

## B. CATEGORIES OF EXCHANGES & PROXIMATE GENERAL TRANSACTIONS

The taxonomy of exchanges and qualified-use exchanges shows that exchanges and proximate general transactions do not fit nicely within a two-by-two matrix that suits exchanges and proximate business transactions.[166] Instead, they fit generally within two broad categories: (1) exchanges before proximate general transactions and (2) exchanges following proximate general transactions. Finally, exchanges and proximate general transactions also include mixed-use and related-party exchanges. Once a set of facts is placed in the right category, the tax outcome generally is fairly certain.

### 1. *Exchange Before Proximate General Transaction*

The category of exchanges that occur before a proximate general transaction is divided between exchanges in which the decision to transfer or convert has been made at the time of the exchange and those in which the decision is made after the exchange. If the facts show the decision to convert was made after the exchanger acquires the replacement property, the exchange satisfies the qualified-use requirement. If the decision has been made to transfer or convert the property at the time the exchanger acquires it, the exchange will not satisfy the qualified-use requirement. The following analysis shows that the most important factor regarding the qualified-use requirement as it applies to exchanges and proximate general transactions is the time at which the exchanger decided to transfer or convert the property to personal use at the time of acquisition.

#### (a) Facts Indicating Change of Intent After Acquisition

In two cases, the Tax Court ruled that an exchanger satisfied the qualified-use requirement even though the exchanger transferred the replacement property or converted it to personal use shortly after acquiring it. In *Wagensen v. Commissioner*, the exchanger first discussed transferring the replacement property with his accountant after acquiring the property.[167] Prior to the transfer, the exchanger used the replacement property in his

165. *See also* Adams v. Comm'r, 105 T.C. M. (CCH) 1029 (holding that a personal residence satisfied the qualified-use requirement even though the exchanger rented it at fair market value to his adult son).
166. *See supra* text following note 81.
167. Wagensen v. Comm'r, 74 T.C. 653, 655 (1980).

ranching business.[168] In *Reesink v. Commissioner*, the exchangers made efforts to rent the property, including showing it to prospective tenants.[169] Only after those efforts proved fruitless and the exchangers' financial situation dictated that they needed to sell their principal residence did they decide to move into the replacement property.[170]

In *Wagensen*, the exchanger held the replacement nine months before transferring it in the same year it was acquired,[171] but the initial discussion with the accountant about the transfer took place shortly after acquisition.[172] The holding period in *Reesink* was eight months, and the conversion occurred in the subsequent year.[173] The legal principle derived from *Wagensen* and *Reesink* is that an exchange satisfies the qualified-use requirement if the exchanger shows the change of holding intent occurred after the acquisition of the replacement property.

In Rev. Rul. 57-244, the exchanger received replacement property as part of a circular exchange pursuant to which three friends transferred property such that at the end of the transaction, they each owned a different property.[174] One of the exchangers sold the acquired property after the exchange.[175] The facts do not indicate how long after the exchange the sale took place, but the IRS granted section 1031 nonrecognition to each of the exchangers, including the one who sold the replacement property after the exchange. Even though Rev. Rul. 57-244 has been around for several decades, it has only been cited in one case by an exchanger who unsuccessfully claimed a transaction satisfied the exchange requirement.[176] The IRS did not express concern about the sale occurring after the exchange affecting the qualified-use requirement.

In P.L.R. 8429039, the exchanger represented that it did not intend to transfer the replacement property for at least two years after the exchange.[177] The facts of the private letter ruling do not indicate whether the exchanger actually held the replacement property for two years.[178] Based upon the holdings in *Wagensen* and *Reesink*, the subsequent holding period would be irrelevant. Thus, if the exchanger in the private letter ruling had changed its holding intent and decided to transfer the property within a few months after acquisition, it could have satisfied the qualified-use requirement because a

168. *Id.* at 658.
169. Reesink v. Comm'r, 103 T.C.M. (CCH) 164 (2012).
170. *Id.*
171. *Wagensen*, 74 T.C. at 658.
172. *Id.* at 656, 659.
173. *Reesink*, 103 T.C.M. (CCH) 164.
174. Rev. Rul. 57-244, 1957-1 C.B. 247.
175. *Id.*
176. *See, e.g.*, Halpern v. United States, 286 F. Supp. 255, 258 (N.D. Ga. 1968) (holding that the transaction was distinguished from Rev. Rul. 57-244 and finding that the transaction failed the exchange requirement), *discussed in* Borden, *Exchange Requirement*, *supra* note 54, at 419–21.
177. I.R.S. Priv. Ltr. Rul. 84-29-039 (Apr. 17, 1984).
178. *See id.*

change in intent after the acquisition does not affect the intent at time of acquisition. Figure 4 summarizes the authority that considers the effect decisions to convert property to a disqualified use after the exchange have on the qualified-use requirement.

| **Figure 4: Decision to Transfer or Convert After Exchange** | | | |
|---|---|---|---|
| **Authority** | **Summary of Facts** | **Satisfied Qualified-Use Requirement** | **Holding Period** |
| Rev. Rul. 57-244 | As part of a circular exchange, *A* acquired lot from *C*, *B* acquired lot from *A*, and *C* acquired lot from *B*. "After the exchange, *A* sold the lot acquired from *C* to another individual." | Yes | N/A Could be very short. |
| *Wagensen* (Tax Court, 1980) | Exchanger acquired replacement property, then talked to CPA about gifting property to adult children, used replacement property in business until gift, and son continued to use property in business after the gift. | Yes | 9 months, (same tax year) |
| P.L.R. 8429039 (Apr. 17, 1984)[179] | At time of acquisition, exchanger intended to hold property for at least two years. Timing of subsequent decision to transfer is indeterminate. | Yes | N/A Facts only considered taxpayer representation at time of acquisition.[180] |
| *Reesink* (Tax Court, 2012) | Exchangers attempted to rent the property after acquisition and showed it to potential renters. Exchangers intended to live in their then-current residence until their 14-year-old son finished high school. Put a for-rent sign on property. Exchanger upset at prospect of selling residence | Yes | 8 months, (next tax year) |

179. Taxpayer returned with revised facts after being denied nonrecognition in I.R.S. Priv. Ltr. Rul. 83-10-016 (Dec. 1, 1982). *See infra* text accompanying note 196 (discussing Priv. Ltr. Rul. 83-10-016).

180. The relevant factual representation under consideration was that the exchanger intended to rent the replacement property for a period of not less than two years after the exchange. Priv. Ltr. Rul. 84-29-039.

| **Figure 4: Decision to Transfer or Convert After Exchange** | | | |
|---|---|---|---|
| **Authority** | **Summary of Facts** | **Satisfied Qualified-Use Requirement** | **Holding Period** |
| | to move into replacement property. Decided to sell then-current residence and move after finding no tenant replacement property. | | |

#### (b) Facts Indicating Intent to Sell or Convert at Time of Acquisition

If the facts indicate that, at the time of the exchange, the exchanger intended to liquidate the replacement property or convert it to personal use, courts hold that the exchange does not satisfy the exchange requirement.[181] In *Regals Realty Co. v. Commissioner*, the board of the corporate exchanger resolved to sell the replacement property within two weeks after its acquisition, its shareholders approved that resolution on that same day, and the corporate officers took actions consistent with the intent to sell the property.[182] In *Black v. Commissioner*, the taxpayer purchased property and immediately began fixing it up for resale.[183] The taxpayer moved into the property because the commute to and from it was inconvenient, and she wanted to devote time to fixing up the property.[184] The taxpayer listed the property with a real estate agent when work was completed, sold it within eight months of the acquisition in the subsequent tax year, and was living it when it sold.[185] The court ruled that the taxpayer held the property primarily for sale at all times following her acquisition of it.[186]

In *Starker v. United States*, one of the replacement properties was a residence that the exchanger directed the exchange partner to transfer directly to the exchanger's daughter, who immediately began using it as a personal residence.[187] The Ninth Circuit recognized that "use of property solely as a personal residence is antithetical to its being held for investment," so the property did not satisfy the qualified-use requirement.[188] In *Land Dynamics*

181. These are the two purposes the Ninth Circuit recognized as antithetical to the section 1031 nonrecognition. Bolker v. Comm'r, 760 F.2d 1039, 1045 (9th Cir. 1985) ("Under this formulation, the intent to exchange property for like-kind property satisfies the holding requirement, because it is *not* an intent to liquidate the investment or to use it for personal pursuits.") (emphasis in original).

182. Regals Realty Co. v. Comm'r, 127 F.2d 931, 933–34 (2d Cir. 1942); Regals Realty Co. v. Comm'r, 43 B.T.A. 194, 203–04 (1940).

183. Black v. Comm'r, 35 T.C. 90, 92 (1960).

184. *Id.*

185. *Id.*

186. *Id.* at 95.

187. Starker v. United States, 602 F.2d 1341, 1350 (9th Cir. 1979).

188. *Id.* at 1350–51.

*v. Commissioner*, the taxpayer transferred property in the tax year following its acquisition of the property.[189] The transfer occurred sometime between ten and twenty-one months after the taxpayer acquired it.[190] The taxpayer was in the business of subdividing and developing property and did not designate the property in question as anything other than property held for that purpose.[191] The court therefore held that the property did not satisfy the qualified-use requirement.

In *Click v. Commissioner*, the exchanger's adult children moved into the residences immediately after acquisition and began making renovations, and the exchanger transferred legal title to the children within six months after acquisition.[192] The court held that the exchanger intended to give the residences to her adult children, so she did not have the requisite investment intent, and thus, the transaction did not satisfy the qualified-use requirement.[193] In *Lindsley v. Commissioner*, the exchanger discussed donating replacement properties to charity after exchange, and the exchanger did transfer most of the replacement properties within eight days after the exchange.[194] The court thus found that the exchanger "plainly did not intend to hold them for investment."[195] In P.L.R. 8310016, the exchanger represented that it would sell the relinquished property on the day of the exchange, and the IRS ruled that the exchange would not satisfy the qualified-use requirement.[196] In *Moore v. Commissioner*, the exchangers acquired lake property with a residence that they used every other weekend for personal pursuits during the summer and sporadically during the rest of the year.[197] The exchangers did not list the property for rental or deduct any expenses for maintenance or other costs associated with the property, and they treated the mortgage on the property as a home mortgage interest, not investment interest.[198] The Tax Court held that the exchanger did not hold the lake property for investment for purposes of section 1031.[199] In *Goolsby v. Commissioner*, the exchangers sold their principal residence prior to the acquisition of the replacement property, moved into the replacement property within two months after the exchange, and made very limited efforts to rent the property.[200] The homeowners association rules may have prohibited

189. Land Dynamics v. Comm'r, 37 T.C.M. (CCH) 1119 (1978).

190. *Id.* (providing that the property was transferred during the subsequent taxable year).

191. *Id.*

192. Click v. Comm'r, 78 T.C. 225, 228–30 (1982). *But see* Adams v. Commissioner, 105 T.C.M. (CCH) 1029 (2013) (holding that personal residence replacement property satisfied the qualified-use requirement even though the exchanger rented the property to his adult son at fair market rent).

193. *Id.* at 234.

194. Lindsley v. Comm'r, 47 T.C.M. (CCH) 540 (1983).

195. *Id.*

196. I.R.S. Priv. Ltr. Rul. 83-10-016 (Dec. 1, 1982).

197. Moore v. Comm'r, 17 T.C.M. 1030 (2007).

198. *Id.*

199. *Id.*

200. Goolsby v. Comm'r, 99 T.C.M. (CCH) 1249 (2010).

renting the property.[201] The court thus held that the exchangers had failed to show that their intent at the time of the exchange was primarily to hold the replacement property for investment or for productive use in a trade or business.[202]

The facts in each of these cases and ruling indicate that, at the time of acquisition, the exchanger intended to sell the replacement property or use it for personal pursuits. In most of the authorities (*Black*, *Land Dynamics*, *Starker*, *Click*, P.L.R. 8310016, and *Moore*), the conversion to personal use or held-for-sale happened at the time of acquisition. In the others (*Regals Realty*, *Lindsley*, and *Goolsby*), nothing happened between the receipt of the property and evidence of a conversion that would signal a change of intent. Thus, the courts were able to conclude that the intent at the time of the acquisition was not investment or business-use. It is the exchanger's intent, at the time the exchanger received the property, to liquidate or convert to personal use that disqualifies the property, not the holding period. Figure 5 summarizes this authority.

**Figure 5:**
**Intent to Sell or Convert at Time of Exchange**

| Category and Authority | Summary of Facts | Satisfied Qualified-Use Requirement | Holding Period |
|---|---|---|---|
| *Regals Realty* (2d Cir., 1942) | The board of a corporation resolved to sell replacement property within 2 weeks after the acquisition, discussed the sale with a broker, and received and rejected other offers. During the year (and at least 6 months) after the acquisition, the corporation contributed the property to a new corporation in exchange for stock. | No | 2 weeks until decision.<br>5+ months until transfer.<br>Next tax year for transfer. |
| *Black* (Tax Court, 1960) | Taxpayer moved into the property immediately after acquisition, began painting it to prepare it for sale, testified that at all times she attempted to sell the property and placed it in the hands of a real estate agent when it was complete, and was living in the house when she sold it 8 months after purchase. | No | 0 months until conversion to held-for-sale.<br>8 months until sale (next tax year). |

201. *Id.* (finding that the exchangers did not research whether the covenants of the homeowners' association would allow the exchangers to rent their property).
202. *Id.*

| Figure 5: Intent to Sell or Convert at Time of Exchange | | | |
|---|---|---|---|
| **Category and Authority** | **Summary of Facts** | **Satisfied Qualified-Use Requirement** | **Holding Period** |
| *Land Dynamics* (Tax Court, 1978) | Exchanger acquired replacement property prior to March 1970. Exchanger sold the replacement property in 1971. Exchanger did not offer the replacement property for sale prior to sale. Prospectus for sale of the stock in exchanger provided that it "acquires land for use in its real estate programs [subdivision and development] and not for investment." No evidence that replacement property was an exception to that general holding purpose. | No | 10–21 months (next tax year) |
| *Starker* (9th Cir. 1979) | Title of replacement residence transferred to exchanger's daughter, but exchanger used the property as personal residence and paid rent to daughter. | No | 0 months |
| *Click* (Tax Court, 1982) | Exchanger transferred relinquished property in exchange for 2 residences. Adult children moved into the residences immediately after closing. Adult children purchased homeowners' insurance for new homes, made renovations, and sold their residences. Exchanger transferred deeds to children in next tax year. | No | 0 months until conversion to personal use. 7 months until transfer of title (next tax year). |
| *Lindsley* (Tax Court, 1983) | Prior to the exchange, exchanger discussed donating the properties to charity. Exchanger donated some of the properties to charity within 8 days after the exchange. | No | 8 days |
| P.L.R. 8310016 (Dec. 1, 1982) | Trust intended to sell replacement property immediately after the exchange. | No | 0 days |

| **Figure 5: Intent to Sell or Convert at Time of Exchange** | | | |
|---|---|---|---|
| **Category and Authority** | **Summary of Facts** | **Satisfied Qualified-Use Requirement** | **Holding Period** |
| *Moore*[203] (Tax Court, 2007) | Taxpayer visited replacement lakefront property 2 weekends per month from mid-March to Labor Day, once or twice in the winter, and once a month during other parts of the year to fish off the dock, listed the property as second residence on the loan documents, did not claim any maintenance deductions, and never rented or attempted to rent the property. | No | 0 days |
| *Goolsby* (Tax Court, 2010) | The events occurred in the following order: (1) exchangers contracted to purchase the replacement property (contingent on sale of personal residence); (2) exchangers contracted to sell relinquished property; (3) exchangers sold relinquished property; (4) exchangers sold residence; (5) exchangers purchased replacement property; (6) exchangers placed rental add for replacement property in neighborhood newspaper without determining if HOA rules allowed rental; (7) exchangers moved into the replacement property. | No | 2 months |

#### (c) Favorable Authority Distinguished from Unfavorable Authority

The fact that appears most important in distinguishing favorable authority from unfavorable authority is the exchanger's ability to show a change in circumstance between the time of acquisition and the time of the subsequent conversion or disposition of the property. If the facts showed that

203. *Moore v. Commissioner* considers both the holding intent of the relinquished property and the holding intent of the replacement property, so it is authority for both an exchange after a failure to change intent prior to an exchange and intent to use property for personal pursuits when acquired. *See infra* Part IV.B.2(b)(1) (regarding exchangers' failure to convert property to qualified use prior to the exchange).

there was no change in circumstance between the time of acquisition and the subsequent conversion or disposition, the courts held that the transaction failed to satisfy the qualified-use requirement.

The holding period is not definitive. In *Reesink* and *Wagensen*, the two cases with favorable rulings, the holding periods were eight and nine months, respectively, and only the holding period in *Reesink* extended into the subsequent taxable year. By contrast, four of the cases with unfavorable rulings—*Regals Realty*, *Black*, *Land Dynamics*, and *Click*—had comparable holding periods—five, eight, seven, and at least ten, respectively. The holding period of the replacement properties in all four of those cases extended into the subsequent taxable year, but the exchanges failed the qualified-use requirement. These results substantiate the position that the length of the holding period and a holding period straddling taxable years does not strengthen an exchanger's qualified-use position. The courts and the IRS are savvy enough to know that holding property for the sake of extending the holding period does not affect the qualified-use requirement.

#### (d) Clearly Distinguished from Exchanges and Proximate Business Transactions

These exchanges that precede a proximate general transaction are clearly distinguished from exchanges that precede a proximate business transaction. When a general transaction follows an exchange, the general transaction terminates the investment in the exchange property or converts the exchange property to a disqualified use. By contrast, a business transaction that follows a business transaction does not terminate the investment or convert the exchange property to a different use; instead, the business transaction is a continuation of the investment in a different form. The distinction is important because if a business transaction follows the exchange, absent any evidence to the contrary (such as that in *Regals Realty*[204]), the exchanger's investment continues following the business transaction. The business transaction itself does not raise questions regarding the qualified-use requirement. On the other hand, a general transaction is evidence that the holding intent changed after the acquisition or the holding intent at the time of acquisition was disqualifying. In the latter situation, the courts must determine if something happened after the acquisition to change the intent or if the exchanger had the disqualified intent at the time the property was acquired.[205]

Exchanges that precede business transactions are distinguished from exchanges that precede general transactions. Thus, authority that addresses exchanges that precede business transactions have no more than very low relevance to exchanges that precede general transactions (i.e., *Magneson* and

204. *See supra* text accompanying note 182.
205. *See supra* Part IV.B.1.

*Maloney*[206] have no relevance to the facts in *Click* or *Goolsby*[207]). Inversely, authority that address exchanges that precede general transactions have no more than very low relevance to exchanges that precede business transactions (i.e., *Click* and *Goolsby* have no relevance to the facts in *Magneson* and *Maloney*).

#### 2. *Exchange After Proximate General Transaction*

Exchanges that occur after a general transaction come within two subgroups: (1) a purchase-transactions subgroup and (2) a conversion-transactions subgroup. Each of those subgroups has two different types of transactions, and the type of transaction determines whether the exchange satisfies the qualified-use requirement.

##### (a) Purchase Transactions

There are two types of exchanges that occur shortly after purchase transactions: (1) contracted-property exchanges and (2) cooperative-buyer exchanges. A review of the authorities shows that the first type of transaction satisfies the qualified-use requirement, but the second type of transaction does not.

##### (1) Contracted-Property Exchange

The facts of a contracted-property exchange are as follows: (1) a purchaser enters into a contract to acquire property (the contracted property) that the purchaser intends to hold for productive use in a trade or business or for investment; (2) before acquiring the contracted property, the purchaser is approached by a party (the interested party) interested in acquiring the contracted property form the purchaser; (3) the purchaser acquires the contracted property; (4) the purchaser transfers the contracted property to the interested party as part of a transaction the purchaser intends to qualify as a section 1031 exchange; and (5) the purchaser uses the proceeds from the sale of the contracted property to acquire other property to be held for productive use in a trade or business or for investment.[208] The authority supporting the application of section 1031 to this type of transaction is very strong.

Almost fifty years ago, in *124 Front Street v. Commissioner*, the Tax Court ruled that a contracted-property exchange qualifies for section 1031 nonrecognition.[209] The decision is highly relevant for any contracted-property exchange, but the analysis was conclusory, especially with respect

206. *See supra* text accompanying notes 42, 46.

207. *See supra* text accompanying notes 192–193, 200–202.

208. For an in-depth discussion of contracted-property exchanges, see Brant J. Hellwig, *The Holding Intent Requirement for Property Transferred in a Section 1031 Exchange*, 45 REAL PROP., TRUST & EST. L. J. 635 (2011).

209. 124 Front Street v. Comm'r, 65 T.C. 6, 15, 18 (1975).

to the qualified-use requirement, because the court did not provide any analysis of that issue. Nonetheless, the Tax Court had considered the qualified-use requirement before its decision in *124 Front Street*,[210] and it considered the qualified-use requirement after.[211] Thus, the Tax Court clearly understood that section 1031 nonrecognition could only be granted if the transaction satisfied the qualified-use requirement. Its holding presupposes a finding that the transaction satisfied the qualified-use requirement, so the lack of analysis of the qualified-use requirement may diminish the strength of the case's persuasiveness some, but the outcome is still very persuasive. An unmodified or overruled decision from the Tax Court that has been in existence for fifty years is a very strong type of authority.

The later holding and analysis in *Bolker* provides a cogent analysis of the qualified-use requirement with respect to exchanges that follow acquisitions of property. In *Bolker*, the court reasoned that if an exchanger acquires property with the intent to exchange it for property to be held for productive use in a trade or business or for investment, the transaction satisfies the qualified-use requirement.[212] The facts of *Bolker* are distinguished from the facts in *124 Front Street* because *Bolker* is a proximate business transaction, while *124 Front Street* is a proximate general transaction. On the other hand, the facts in *Bolker* are similar to the facts in *124 Front Street* because, in both cases, the exchanger acquired and transferred replacement property as part of an exchange intended to qualify for section 1031 nonrecognition. The similarity of the facts in these two cases is more important than their differences because, in both cases, the exchanger continues an investment through the exchange. That distinction should not matter because the acquisition in *124 Front Street* signaled the beginning of an investment in real property, and the exchange was a continuation of that investment. Even though the exchanger in *Bolker* did not start the investment in real property right before the exchange (the exchanger continued the investment in property acquired from the corporation in modified form), the timing of the start of an investment appears to have no significance. Thus, *Bolker* is strongly persuasive authority for contracted-property exchanges, and it strengthens the *124 Front Street* authority supporting the position that contracted-property exchanges satisfy the qualified-use requirement.

General principles of tax law and section 1031 also support treating the exchanger in a contracted-property exchange as starting the investment with the contract or option to purchase,[213] continuing the investment through the

210. *See, e.g.*, Black v. Comm'r, 35 T.C. 90 (1960); Regals Realty Co. v. Comm'r, 43 B.T.A. 194 (1940); *infra* Appendix A attached hereto listing the qualified-use authorities.

211. *See, e.g.*, Maloney v. Comm'r, 93 T.C. 89 (1989); Click v. Comm'r, 78 T.C. 225 (1982); Wagensen v. Comm'r, 74 T.C. 653 (1980); *infra* Appendix A (listing the qualified-use authorities).

212. Bolker v. Comm'r, 760 F.2d 1039, 1045 (9th Cir. 1985); *supra* text accompanying note 45.

213. Tax law generally treats the acquisition of property upon the exercise of an option to acquire property as a continuation of the investment in the option. For instance, the holding period and cost

acquisition of the property, and then exchanging into the replacement property. Congress recognizes this origination-of-investment concept by requiring the character of gain or loss attributable to the sale or exchange of or failure to exercise an option to be the same as what the character of gain or loss would be on the sale or exchange of the property to which the option relates.[214] The in-lieu-of principle is similar in that it determines the character of a payment in a legal settlement or judgment to be the same character of the payment that the taxpayer would have received without the legal disruption.[215] Thus, with contracted-property exchanges, the investment does not appear to begin with the acquisition of the property; it begins with the acquisition of the right to acquire the property. If that investment begins prior to the exchange receiving an offer on the property, then the exchange of such property can satisfy the qualified-use requirement. If the exchanger's intent in acquiring the contracted-property was for a disqualified use, then the acquisition of such property would not change that intent, and the subsequent exchange of such property should not qualify for section 1031 nonrecognition. Figure 6 summarizes the authority that has ruled with respect to a contracted-property exchange.

of an option are added to the holding period and basis, respectively, of the option property. I.R.C. § 1223(a); Rev. Rul. 78-182, § A.4, 1978-1 C.B. 265. This analysis considers the situation in which the exchanger acquires the property and then exchanges it. The exchanger could consider selling the contract. If the contract meets the definition of real property, which it could under the section 1031 definition of real property in Treas. Reg. § 1.1031(a)-3(a)(5)(i) (defining real property to include certain real property that derives its value from real property and is inseparable from that real property), and is like-kind to real property, it could qualify as valid section 1031 exchange property. When considering whether two interests in real property are like-kind, courts and the IRS consider the duration of the rights, considering whether the rights are equivalent to perpetual. *See, e.g.*, Wiechens v. United States, 228 F. Supp. 2d 1080, 1085 (D. Ariz. 2002) (holding that non-perpetual water rights, which were real property under state law, were not like-kind to a general interest in real property); Rev. Rul. 55-749, 1955-2 C.B. 472 (ruling that perpetual waters right, which were real property under state law, were like-kind to a general interest in real property). Leases of thirty years or more in real property are like-kind to general interests in real property. Treas. Reg. § 1.1031(a)-1(3)(c)(2). The periods of renewal options on a lease count in determining whether the lease has thirty years or more to run. *See* Century Elec. Co. v. Comm'r, 192 F.2d 155, 158 (8th Cir. 1951); R&J Furniture Co. v. Comm'r, 10 T.C. 857, 865 (1953). Because an option and contract to purchase property can mature into a fee interest in real property upon exercise of the right to acquire property, arguably, that maturity feature should be considered in determining the term of the right (much as renewal options on lease are taken into account), giving them the perpetuity needed to be deemed like-kind to a general interest in real property.

214. I.R.C. § 1234(a)(1).

215. *See, e.g.*, Freda v. Comm'r, 656 F.3d 570 (7th Cir. 2011) (finding that payments were in lieu of lost profits, not a return of capital); Raytheon Prod. Corp. v. Comm'r, 144 F.2d 110 (1st Cir. 1944), *cert. denied*, 312 U.S. 779 (1944) (providing that the question on remand was to determine what the payment in lieu of).

| Figure 6: Contracted-Property Exchange | | | |
|---|---|---|---|
| **Authority** | **Summary of Facts** | **Satisfied Qualified-Use Requirement** | **Holding Period** |
| *124 Front Street* (Tax Court, 1975) | Exchanger had an option to acquire real property (option property). Exchanger entered into an agreement to sell the property. Purchaser offered to purchase the property. Purchaser advanced funds to allow Exchanger to acquire the option property. Deed to the option property was transferred and held in trust for the benefit of Purchaser. Exchanger reported ownership of the option property on its tax return for the year of acquisition and received rent from the property. Early in the next tax year, Purchaser offered to purchase Exchanger's replacement property from a third party. Purchaser acquired replacement property and immediately transferred it to Exchanger in exchange for the option property. | Yes | 6 months (next tax year) |

**(2) Cooperative-Buyer Exchange**

The facts of a cooperative-buyer exchange are as follows: (1) an interested purchaser expresses interest in acquiring property (the desired property); (2) the owner makes the transfer of the desired property to the interested purchaser conditioned on the interested purchaser acquiring like-kind property and transferring it to the owner to allow the owner to complete a section 1031 exchange; (3) the interested purchaser, at the direction of the owner, locates and acquires other property (consideration property); and (4) the interested purchaser transfers the consideration property to the owner in exchange for the desired property.

Cooperative-buyer exchanges have been considered by three authorities, each of which denied section 1031 nonrecognition to the interested purchaser. First, in Rev. Rul. 77-297, the IRS ruled that a cooperative buyer did not qualify for section 1031 nonrecognition.[216] The interested purchaser in that ruling approached the owner of property with an interest in acquiring the owner's property (the desired property).[217] The owner made a sale of the desired property conditioned upon the interested purchaser acquiring and

216. Rev. Rul. 77-297, 1977-2 C.B. 304.
217. *Id.*

transferring other property (the consideration property) to the owner as consideration for the owner's property.[218] The interested purchaser acquired and transferred the consideration property pursuant to the owner's direction, and the IRS ruled that the owner could satisfy the qualified-use requirement, but the interested purchaser could not.[219] In *Barker v. United States*, a district court held that a cooperative buyer did not qualify for section 1031 nonrecognition.[220] (In *Barker v. United States*, the Tax Division of the U.S. Department of Justice took the position that *Bolker* supported granting section 1031 nonrecognition to the transaction because the cooperative buyer did not intend to liquidate the consideration property or use it for personal pursuits.[221]) The facts of the case are similar to those in Rev. Rul. 77-297.[222] In both the ruling and the case, the taxpayer had no intention of acquiring the consideration property prior to the seller expressing an interest in receiving property as consideration. Thus, the exchanger had no prior investment or intent to acquire the consideration property to hold for productive use in a trade or business or for investment.

Cooperative-buyer exchanges are distinguished from contracted-property exchanges in two significant ways. First, the cooperative buyer never intended to acquire the consideration property to hold for productive use in a trade or business or for investment. Consequently, the cooperative buyer could not continue an investment in the desired property. Instead, the cooperative buyer's investment begins with the acquisition of the desired property. The lack of continuity of investment places the transaction beyond section 1031's purpose of granting nonrecognition to transactions that continue an investment.[223]

Second, any income the cooperative buyer obtains from acquiring and transferring the consideration property is comparable to compensation for services because the cooperative buyer acts under the direction of the seller to acquire and transfer the consideration property. Such a position is consistent with the ordinary-income treatment afforded gain on the sale of property held primarily for sale to customers in the ordinary course of a trade or business.[224] With such transactions, the change in value of property can be attributed to the property owner's efforts, and such gain from the sale should

218. *Id.*
219. *Id.*
220. Barker v. United States, 668 F. Supp. 1199 (C.D. Ill. 1987).
221. *Id.* at 1202; *see supra* note 52 and accompanying text.
222. *Barker*, 668 F. Supp. at 1199–200.
223. *See supra* Part III.B.1.
224. I.R.C. § 1221(a)(1) (excluding such property from the definition of capital asset).

not qualify for favorable tax treatment,[225] including nonrecognition of gain under section 1031.[226]

*Rutherford v. Commissioner* falls within the cooperative-buyer category.[227] In that case, the taxpayer acquired twelve half-blood heifers in the exchange for the promise to breed them and transferred twelve three-quarter-blood heifer offspring as consideration for the half-blood heifers.[228] The three-quarter-blood heifers therefore became the consideration property that the taxpayer was to acquire and transfer to the seller of the half-blood heifers. The court ruled that the transaction qualified for section 1031 nonrecognition, presupposing the taxpayer held the three-quarter-blood heifers for productive use in a trade or business or for investment.[229] The *Rutherford* result has some support from the continued-investment purpose of section 1031. The exchanger acquired and owned the half-blood heifers for investment or use in a trade or business, and the three-quarter-blood heifers could be considered to be a continuation of the investment in the half-blood heifers. That reasoning is not strong, but it may help explain the court's reasoning. Otherwise, the exchanger appeared to be acting at the direction of the seller and to be providing services to birth and wean the three-quarter-blood heifers. This ruling provides an unexpected result, but because section 1031 no longer applies to personal property, and *Rutherford* has very unique facts, the ruling has limited utility under current law.[230] *Rutherford*'s distinguishable facts would give it weak relevance, and its lack of reasoning makes its persuasiveness weak for typical real estate cooperative-buyer exchanges. Figure 7 summarizes the authority that considers the qualified-use question with respect to exchanges that occur after proximate general transactions.

225. Malat v. Riddell, 383 U.S. 569, 572 (1966) ("The purpose . . . is to differentiate between the profits and losses arising from the everyday operation of a business on the one hand and the realization of appreciation in value accrued over a substantial period of time on the other." (citations and internal quotation marks omitted)).

226. I.R.C. § 1031(a)(2) (excluding exchanges of real property held primarily for sale from the application of section 1031).

227. Rutherford v. Comm'r, 37 T.C.M. (CCH) 1851-77 (1978).

228. *Id.*

229. *Id.*

230. Perhaps it could be interpreted to apply to property to be constructed. For instance, perhaps it could be applied to an option to acquire real property to be constructed. Options to acquire real property can be real property. Treas. Reg. § 1.1031(a)-3(a)(5)(i). An option to acquire property to be constructed applies to property that does not exist at the time of the exchange but will come into existence at a later time, so it is similar in some respect to a calf to be born.

**Figure 7:**
**Exchanges After Proximate General Transactions (Cooperative-Buyer Exchange)**

| Authority | Summary of Facts | Satisfied Qualified-Use Requirement | Holding Period |
|---|---|---|---|
| Rev. Rul. 77-297 | After entering into a contract to purchase property from the seller, the cooperative buyer, at the seller's direction, acquired the consideration property and transferred it to the seller. | No | 0 days |
| *Rutherford* (Tax Court, 1978) | The exchanger promised to breed 12 half-blood heifers and transfer 12 three-quarter-blood heifer offspring to the seller. The exchanger transferred offspring after they were weaned, which was approximately 3 to 6 months after acquisition by birth.[231] | Yes | 3–6 months |
| *Barker v. U.S.* (District Court, 1987) | The cooperative buyer entered into an agreement to acquire desired property. The seller required the cooperative buyer to acquire and transfer consideration property to facilitate the seller's exchange. The cooperative buyer looked for the seller's replacement property (consideration property) for approximately 8 months and acquired it approximately 10 months after entering into the original agreement. The cooperative buyer immediately transferred the consideration property to the seller in exchange for the seller's property. The cooperative buyer argued that the transaction was not an exchange to qualify for a credit unrelated to section 1031.[232] (Government argued *Bolker* should have applied.) | No | 0 days |

231. The holding period estimate is based upon information provided to the Author by Max Hansen, a section 1031 professional and cattleman.

232. Typically, the cooperative buyer does not recognize gain because the purchase price of the facilitation property will equal the value of the cooperative buyer's desired property. *Barker* raised a section 1031 issue related to the basis of property for credit purposes, not section 1031 purposes. Barker v. United States, 668 F. Supp. 1199, 1201 (C.D. Ill. 1987).

**(b) Conversions**

The second subgroup of exchanges that occur after general transactions includes conversion transactions. For an exchange to satisfy the qualified-use requirement after the conversion, the property must successfully convert from a disqualified-use property to a qualified-use property. In other situations, the conversion can be successful. Failure to convert the property to a qualified use results in the transaction failing to satisfy the qualified-use requirement. Reverse conversion (converting from a qualified use to a disqualified use) would be atypical, and no authority appears to address such reverse conversions.

**(1) Failure to Convert to Investment or Business-Use Property**

The first type of exchange in this subgroup is one that occurs when an exchanger fails to convert property from some prior use to a qualified use. The authority considering this type of exchange show that the manner in which exchangers account for and treat property while holding it determines the use at the time of the exchange. Factors such as a lengthy holding period and holding property across tax years do not appear to affect the outcome.[233] Two cases consider exchanges of property that the exchanger did not convert to a qualified-use property prior to the exchange.

First, in *Neal T. Baker v. Commissioner*, the exchanger held the property for eleven years prior to transferring it as part of an exchange the exchanger claimed should qualify for section 1031 nonrecognition.[234] During that period, the taxpayer made efforts to obtain plan approval for a subdivision and carried the property on its books as a work-in-progress.[235] The court found no evidence that the holding intent ever changed to investment or business-use, so the property did not satisfy the qualified-use requirement.[236] Second, in *Moore v. Commissioner*, the exchangers transferred lakefront real property they held for approximately twelve years as part of a transaction they intended to have qualify for section 1031 nonrecognition.[237] During those twelve years, the exchangers used the property as a frequent weekend home during the summers and took home mortgage interest deductions on the property's mortgage.[238] Furthermore, the exchangers never listed the property for sale or rent and did not take any deductions for investment

233. *See, e.g.*, Neal T. Baker Enters. v. Comm'r, 76 T.C.M. (CCH) 301 (1998) ("The fact that land was held for many years does not, by itself, establish an intention to hold the property for investment rather than sale.")

234. *Id.*

235. *Id.*

236. *Id.*

237. Moore v. Comm'r, 93 T.C.M. (CCH) 1275 (2007).

238. *Id.*

interest or maintenance and other expenses related to the property.[239] The Tax Court held that the property failed to satisfy the qualified-use requirement.[240]

Both of these cases are strong contrary authority for exchanges of property that have been treated as property held for development and sale or for personal use prior to their disposition. The cases are relevant for transactions that have similar facts related to use prior to an exchange. Both decisions apply the law cogently to facts, so they are persuasive, and the tax court decisions have been in effect for twenty-six years and seventeen years, respectively. Figure 8 summarizes the authority that considers exchanges that occur when an exchanger fails to convert the exchange property to a qualified use prior to the exchange.

**Figure 8:**
**Exchanges After Proximate General Transactions**
**(Failure to Convert to Investment or Business-Use Property)**

| Authority | Summary of Facts | Satisfied Qualified-Use Requirement | Holding Period |
|---|---|---|---|
| *Neal T. Baker* (Tax Court, 1998) | Taxpayer, a real estate subdivider and developer, acquired property to construct single-family homes for sale, made efforts to obtain plan approvals, carried the property on its books as a work-in-progress, and did not establish that it discontinued its plan to develop the property before transferring it as part of an exchange. | No | 11 years (next tax year) |
| *Moore*[241] (Tax Court, 2007) | Taxpayer held lakefront property for about 12 years, used it with family, never advertised property for sale or attempted to rent it, and took home mortgage interest deduction for it. | No | 144 (next tax year) |

#### (2) Conversion to Investment or Business-Use Property

Apparently, no authority directly addresses a situation in which an exchanger converted disqualified-use property to qualified-use property and qualified for section 1031 nonrecognition. The lack of such authority should not be interpreted to mean that that an exchanger cannot convert disqualified-

239. *Id.*
240. *Id.*
241. *Moore v. Commissioner* considers both the holding intent of the relinquished property and the holding intent of the replacement, so it is authority for both an exchange after a failure to change intent prior to an exchange and intent to use property for personal pursuits when acquired. *See supra* Part IV.B.1(b) (discussing the intent to use replacement property for personal pursuits when acquired).

use property to qualified-use property. Courts, including the Tax Court in *Neal T. Baker*,[242] recognize that a property owner's holding intent can change. In multiple non-section 1031 cases, courts have considered whether property owners have converted personal-use property to investment or business-use property. Courts have also considered whether property owners have successfully converted property held primarily for sale to customers in the ordinary course of a trade or business to investment or business-use property. Those authorities could be relevant to transactions in which exchangers attempt to convert personal-use or held-for-sale property to investment or business-use property prior to exchanging such property.[243] The following discussion demonstrates, however, that no clear rules emerge from those authorities.

Multiple provisions of federal income tax law adopt some version of property held for use in a trade or business or for investment. For instance, the depreciation deduction is allowed only with respect to "property used in a trade or business" or held for "the production of income;"[244] loss limitations do not apply to losses "incurred in a trade or business" or "incurred in any transaction entered into for profit;"[245] capital assets excludes "property held . . . primarily for sale to customers in the ordinary course of [a] trade or business;"[246] and the rules of section 1231 only apply to "property used in a trade or business."[247] While that language is not identical to section 1031's "productive use in a trade or business or investment," the language is similar, and courts considering the section 1031 qualified-use question often refer to those other areas of tax law. For instance, in *Starker*, the Ninth Circuit drew from the loss-limitation rules in analyzing whether a personal-use residence was held for investment for section 1031 purposes, concluding that "[a] similar rule must obtain in construing the term 'held for investment.'"[248] In *Neal T. Baker*, the Tax Court applied the section 1221 analysis that determines whether property is dealer property or a capital asset.[249]

Section 1031 specifically excludes property an exchanger holds or acquires to hold primarily for sale,[250] so if the property is dealer property, which includes "property held by the taxpayer primarily for sale to customers

242. Neal T. Baker Enters. v. Comm'r, 76 T.C.M. (CCH) 301 (1998) ("'[W]hile the purpose for the acquisition must be given consideration, intent is subject to change, and the determining factor is the purpose for which the property is held at the time of' the exchange. Eline Realty Co. v. Comm'r, 35 T.C. 1, 5 (1960)").

243. Moore v. Comm'r, 93 T.C.M. (CCH) 1275 ("Thus, both section 1031 and 212(2) involve the same factual inquiry whether the property in question was held for investment.").

244. I.R.C. § 167(a).

245. *Id.* § 165(c).

246. *Id.* § 1221(a)(1).

247. *Id.* § 1231(a)(3)(i).

248. Starker v. U.S., 602 F.2d 1341, 1350–51 (9th Cir. 1979).

249. *Neal T. Baker Enters.*, 76 T.C.M. (CCH) 301 (citing Malat v. Riddell, 383 U.S. 569, 572 (1966); Maddux Constr. Co. v. Comm'r, 54 T.C. 1278, 1284 (1970)).

250. I.R.C. § 1031(a)(2).

in the ordinary course of the [taxpayer's] trade or business,"[251] it will not satisfy the qualified-use requirement.[252] Section 1031 also excludes property held for personal use,[253] so if property comes within the definition of personal use under another provision of tax law, it most likely would not satisfy the qualified-use requirement.[254] Thus, cases that consider conversions prior to dispositions in other contexts could be relevant to the qualified-use question in exchanges that follow conversions of property.

Many cases address attempted conversions prior to dispositions of property. For instance, the Supreme Court and Tax Court have held that a taxpayer who moved out of a residence, listed it with an agent for rent or sale, and rented it out continuously for some period successfully converted the property to rental property used in a trade or business by the taxpayer.[255] The rental periods in those cases were twenty years and more than three years, respectively.[256] The rulings did not appear to intend to establish a minimum rental period of three years, so no holding-period inference should be drawn from them. In other cases, the court found a vacated principal residence was held for production of income even though the taxpayer only listed it for sale and made some renovations but never listed it for rent.[257] These cases illustrate that conversion from personal use to qualified use prior to an exchange is possible.

Other cases find that property owners failed to convert property from personal use prior to a disposition. Courts have held that merely listing personal-use property for sale or rent does not convert such property to investment or business-use property.[258] The length of time the property sat on the market after the taxpayer discontinued personal use did not appear to be definitive in those cases, as the time the property was listed for sale ranged

251. *Id.* § 1221(a)(1).

252. *Neal T. Baker Enters.*, 76 T.C.M. (CCH) 301 ("Because section 1031 . . . deals only with property 'held primarily for sale,' this is the only requirement for the applicability of the exception to section 1031.").

253. *See Starker*, 602 F.2d at 1350–51; Rev. Rul. 59-225, 1959-2 C. 180 (concluding that section 1031 does not apply to gain or loss from an exchange of a personal residence).

254. For example, a property that is personal use for purposes of the depreciation deduction or loss rules, most likely would be personal-use property for purposes of section 1031.

255. *See, e.g.*, Heiner v. Tindle, 48 S. Ct. 326 (1928); Hazard v. Comm'r, 7 T.C. 372 (1946).

256. *Heiner*, 48 S. Ct. at 326 (rented out for almost twenty years after conversion); *Hazard*, 7 T.C. at 373 (rented out continuously for more than three years after conversion).

257. *See, e.g.*, Briley v. United States, 189 F. Supp. 510 (N.D. Ohio 1960) (allowing deductions for vacated residence that was vacant for less than two years during which time the taxpayers listed the property for sale and rent but did not rent it out); Robinson v. Comm'r, 2 T.C. 305 (1943) (allowing deductions incurred with respect to a vacated residence listed for sale or rent for more than five years that was never rented, even though a detached garage on the property was rented); Smith v. Comm'r, 26 T.C.M. (CCH) 149 (1967).

258. *See, e.g.*, May v. Comm'r, 299 F.2d 725 (4th Cir. 1962); Rumsey v. Comm'r, 82 F.2d 158 (2d Cir. 1936); Newcombe v. Comm'r, 54 T.C. 1298 (1970) (holding that placing a former residence on the market for sale does not convert it to property held for production of income); Cowles v. Comm'r, 29 T.C.M. (CCH) 884 (1970).

from five years[259] to more than two years[260] to more than one year[261] to less than one year.[262] Excerpts from two decisions reveal the lack of bright-line rules for establishing whether a conversion from personal use has been successful. For instance, the Fourth Circuit stated:

> The most telling deficiency in the taxpayer's case is the failure to demonstrate an affirmative conversion of the property to a potentially income-yielding asset. Renunciation and abandonment of the ship for personal use are but stages of transition to income-producing statute. Alone, they would not change the yacht's function from fun-making to money-making, and they did not in this instance establish her owner as a rentier. Nothing positive to indicate such conversion is brought out in the taxpayer's presentation.[263]

The Tax Court also considered whether an exchange had converted personal-use property to investment or business-use property and presented a version of the legal situation this way:

> The placing of the property on the market for immediate sale, at or shortly after the time of its abandonment as a residence, will ordinarily be strong evidence that a taxpayer is not holding the property for post-conversion appreciation in value. Under such circumstances, only a most exceptional situation will permit a finding that the statutory requirement has been satisfied. On the other hand, if a taxpayer believes that the value of the property may appreciate and decides to hold it for some period in order to realize upon such anticipated appreciation, as well as an excess over his investment, it can be said that the property is being "held for the production of income."[264]

That description of the law governing pre-transfer conversion suggests that time could be a factor in the determination, but the cases otherwise demonstrate there is no bright-line rule for determining whether personal-use property has been converted to qualified-use property. Additional analysis, including reading more cases that consider pre-transfer conversions and classifying each, could produce greater clarity, but that analysis is beyond the scope of this Article. In areas of the law such as this, where bright-line rules cannot be drawn and the facts of the various cases do not lend themselves to categorization, courts are left to apply facts-and-circumstances tests to rule with respect to any set of facts that deviates from the norm. Exchanges that follow conversions are the one type of exchange for which section 1031 and other authorities do not provide clear guidance.

259. *May*, 299 F.2d at 727.
260. *Cowles*, 29 T.C.M. (CCH) 884.
261. *Newcombe*, 54 T.C. at 1298–99.
262. *Rumsey*, 82 F.2d at 158.
263. *May*, 299 F.2d at 728.
264. *Newcombe*, 54 T.C. at 1302–03.

This discussion of authorities that address conversions from disqualified use to qualified use shows that the law related to conversions prior to exchanges is uncertain. The relevance of these authorities to other types of exchanges is very low because the facts of these cases are limited to conversions that precede exchanges. Thus, the uncertainty with respect to this single type of exchange cannot be extended to other types of exchanges for which relevant authorities provide greater certainty. The space created by the lack of clarity in this area lends itself to safe-harbor guidance from the IRS, which it has filled with Rev. Proc. 2008-16.[265] That safe-harbor guidance is also limited to specific types of exchanges and has no, or very little, relevance beyond those transactions to which it is prescribed.

### 3. *Limited Application of a Two-Year Period*

The analysis now turns to two section 1031 authorities that include a two-year holding period—the safe harbor for mixed-use property and the rule governing related-party exchanges. These two-year authorities have specifically prescribed applications and have no, or very little relevance, beyond their prescribed scopes. In fact, the authorities cannot read as requiring a two-year holding period for any reason other than obtaining the specific tax benefit to which the authorities apply, so any other reliance upon them as authority is misplaced.

#### (a) Mixed-Use Safe-Harbor Time Period

Mixed-use property is property used for personal purposes and for business or investment purposes. Several use arrangements come within the definition of mixed-use property. First, mixed-use property includes a single property that is used concurrently for personal and business purposes. A property that is used as a principal residence and a business office or a commercial automotive shop is mixed-use property. The IRS provides guidance for applying section 1031 and section 121 (the exclusion of gain on the sale of a principal residence) to the exchange of such property in Rev. Proc. 2005-14.[266] Such ownership arrangements may require determining the portion of the property used as a principal and the portion used for business.[267] The portion of the property that is used as a principal residence does not satisfy the qualified-use requirement, but the business-use portion can.[268] The direction provided in Rev. Proc. 2005-14 does not include guidance for determining whether the property is held for productive use in a trade or business or for investment.

265. Rev. Proc. 2008-16, 2008-1 C.B. 547.
266. Rev. Proc. 2005-14, 2005-1 C.B. 528.
267. *Id.* § 5, Examples 2, 3.
268. *Id.*

Third, mixed-use property can include property that the owner successively uses for personal pursuits and investment or business-use property (successive mixed-use property). With such property, the question under section 1031 is whether the property owner has converted relinquished property to a qualified use prior to the disposition and has acquired the replacement property for personal use at the time it is received. If the conversion has been successful, then section 121 may apply to a portion of the gain and section 1031 could apply to another portion of the gain if the converted property is exchanged for like-kind property.[269] The direction provided in Rev. Proc. 2005-14 does not include guidance for determining if the exchanger has successfully converted the property from personal-use to qualified-use property.

Third, mixed-use property includes property that is alternatively rented out and used for business purposes successively over a given period of time (alternating mixed-use property). A vacation home that the owner rents out when not using it for personal pursuits is this type of property. With such property, the question is whether the personal-use rises to a level that causes the property to be personal-use property that fails the qualified-use requirement. The cases discussed above may provide some guidance, but that guidance is not definitive.

There are two gaps in the section 1031 rulings: (1) with respect to successive-use property, whether an exchanger has done enough to convert personal-use property to qualified-use property prior to disposing of it; and (2) with respect to alternating-use property, whether an exchanger's personal use of property causes it to lose its investment or business-use classification. Because case law does not provide sufficient clarity with respect to these two gaps, property owners who are selling property may be concerned that actions they have taken to convert a personal-use residence to qualified-use property may not be sufficient to satisfy the qualified-use requirement. Exchangers who have used rental property for personal use may be concerned that the personal use has caused the property to become personal-use property that will fail the qualified-use requirement. *Moore v. Commissioner* causes concern for exchangers who have used property for personal pursuits.[270]

A combination of uncertainty regarding the law governing alternating-use and successive-use properties and the frequency with which this issue can arise led the IRS to publish the Rev. Proc. 2008-16 safe harbor.[271] The safe harbor in Rev. Proc. 2008-16 provides conditions "under which the [IRS] will not challenge whether a dwelling unit qualifies as property held for productive use in a trade or business or for investment for purposes" of

269. *Id.* § 5, Example 1.

270. Moore v. Comm'r, 93 T.C.M. (CCH) 1275 (2007); *see supra* text accompanying notes 197–199, 237–241 (discussing *Moore*).

271. Rev. Proc. 2008-16, 2008-1 C.B. 547.

section 1031.[272] The safe harbor applies if, during each year during a two-year period before and after an exchange, the exchanger's personal use of the exchange property (which must be a dwelling unit) does not exceed the stated threshold, and the exchanger rents the property out for a sufficient period.[273] The IRS specifically limits the application of the safe harbor to exchanges of dwelling units that meet those standards.[274]

This safe harbor does not create substantive law; it merely conveys the IRS's procedural posture related to specific types of transactions or situations specified in the revenue procedure. The IRS's commitment not to challenge the position provides certainty to exchangers who satisfy the conditions in the safe harbor. The IRS should be estopped from taking a position contrary to the position stated in Rev. Proc. 2008-16, so it could not claim that an exchange that satisfies the safe-harbor conditions does not satisfy the qualified-use requirement. If, however, a situation that satisfied the conditions in Rev. Proc. 2008-16 were to be considered by a court, the court could rule that the situation did not satisfy the qualified-use requirement.[275]

Because Rev. Proc. 2008-16 is merely a safe harbor, it does not create an analytical framework for considering the effect time has on determining whether property satisfies the qualified-use requirement. The IRS does not provide any rationale for choosing the two-year period, so exchangers have no analysis to draw from to extrapolate the two-year period to other transactions. Furthermore, the IRS does not explain how the personal-use limitation and the minimal rental requirement relate to the two-year period, if at all. Thus, there is no basis for claiming that the two-year holding period in the Rev. Proc. 2008-16 has any relevance to exchanges that do not meet the safe-harbor conditions. Exchangers cannot infer that a two-year holding period is required or sufficient to establish that the qualified-use requirement is satisfied with any type of exchange that does not satisfy the Rev. Proc. 2008-16 standards.

The two-year period in Rev. Proc. 2008-16 appears to be arbitrary and has no relevance beyond the transactions that do not satisfy the safe-harbor conditions. Exchangers with much shorter holding periods prior to converting property to personal use have obtained rulings from courts that their

272. *Id.* § 1.

273. *Id.* § 4.02.

274. *Id.* § 3.01.

275. Because the IRS cannot take a position contrary to the position in Rev. Proc. 2008-16, the issue would have to be raised by another party. The obvious venue for a challenge to the tax treatment provided for in Rev. Proc. 2008-16 is a tax controversy, but the tax aspects of transactions can arise in other cases. For instance, whether a transaction qualifies for section 1031 nonrecognition could be an issue in a quiet title claim or business dispute. *See, e.g.*, NES Fin. Corp. v. JPMorgan Chase Bank, 907 F. Supp. 448 (S.D.N.Y. 2012). One would anticipate that a court would find a situation that satisfied the Rev. Proc. 2018-16 conditions meets the qualified-use requirement, but the court would not be bound by the revenue procedure.

exchanges satisfy the qualified-use requirement.[276] Thus, although Rev. Proc. 2008-16 is strong authority for exchanges of property that meets its conditions, its relevance beyond such situations is very weak. For instance, the exchangers in *Moore*, who frequently used lakefront property,[277] could not rely upon the two-year holding period to claim their property satisfied the qualified-use requirement. Furthermore, Rev. Proc. 2008-16 is not negative authority for a case such as *Reesink*, in which the exchanger converted replacement property to personal use eight months after acquisition.[278]

### (b) Related-Party Exchange Time Period

The related-party rules do not address the qualified-use requirement; rather, the related-party rules are concerned with basis-shifting and cashing out.[279] These rules provide that an exchange between related parties can qualify for section 1031 nonrecognition if neither of the parties to the exchange transfers the exchange properties within two years following the exchange.[280] Congress provided, however, that tax-free transfers during the two-year period do not trigger gain recognition.[281] Because the related-party rules do not address the qualified-use requirement, they are not relevant to the qualified-use question. Figure 9 summarizes the section 1031 authority that includes a two-year holding requirement.

**Figure 9: Limited-Application Safe-Harbor Holding Periods**

| Category and Authority | Summary of Facts | Satisfied Qualified-Use Requirement | Holding Period |
|---|---|---|---|
| Rev. Proc. 2008-16 | The IRS will not challenge whether the qualified-use requirement is satisfied if: (1) The property is a dwelling unit owned by exchanger for 24 months; | Yes | 2 years |

276. *See, e.g.*, Reesink v. Comm'r, 103 T.C.M. (CCH) 1647 (2012); *see supra* text accompanying notes 169–173.

277. *See* Moore v. Comm'r, 93 T.C.M. (CCH) 1275 (2007); *see supra* text accompanying notes 197–199, 237–241 (discussing *Moore*).

278. *Reesink*, 103 T.C.M. (CCH) 1647; *see supra* text accompanying notes 169–173 (discussing *Reesink*).

279. *See supra* note 116 and accompanying text.

280. I.R.C. § 1031(f)(1).

281. *Id.* § 1031(f)(2)(A), (B) (disregarding transfers as a result of death or involuntary conversions of property); H.R. REP. NO. 101-247, at 1341 (1989) ("A disposition would include, however, all other transfers of the property, such as tax-free transfers to a corporation (pursuant to [Section] 351) or to a partnership (pursuant to [Section] 721), unless it is established to the satisfaction of the Secretary of the Treasury that neither the exchange nor the disposition had as one of its principal purposes the avoidance of Federal income tax.").

| **Figure 9: Limited-Application Safe-Harbor Holding Periods** | | | |
|---|---|---|---|
| **Category and Authority** | **Summary of Facts** | **Satisfied Qualified-Use Requirement** | **Holding Period** |
| | (2) exchanger rents the property to another party for at least 14 days during each 12-month period; and (3) exchanger's personal use of property does not exceed greater of 14 days or 10 percent of rental during 12-month periods. | | |
| Section 1031(f) | Applies to related-party exchanges. Taxable transfers within 2 years after related-party exchange trigger gain recognition. Taxable transfers after 2 years do not trigger gain recognition. No analysis of actual intent.[282] | N/A | 2 years |

## V. GENERAL OBSERVATIONS

The analysis thus far has focused on classifying qualified-use authorities and examining their technical determinations. This Part of the Article draws from that discussion of specific rulings to provide general observations and address misperceptions about the qualified-use requirement.

### A. GENERAL CONCLUSIONS

The analysis above, along with the groupings, leads to several general conclusions regarding exchanges and proximate general transactions.

#### 1. *Exchanges & Proximate Business Transactions*

The weight of authority for the position stated by the Tax Court in *Maloney* is extremely strong: "A trade of *property A* for *property B*, both of like kind, may be preceded by a tax-free acquisition of *property A* at the front end, or succeeded by a tax-free transfer of *property B* at the back end."[283] That is the blackletter law regarding exchanges and proximate business transactions. *Regals Realty* is the only existing authority that is an exception to that rule, but the facts in that case are specific and distinguished from the typical exchange and proximate business transaction, so it is not relevant to

282. Any arrangement that substantially diminishes the risk of loss with respect to exchange property shall suspend the running of the two-year period.

283. Maloney v. Comm'r, 93 T.C. 89, 98 (1989).

typical exchanges that occur in proximity to business transactions.[284] The revenue rulings from the 1970s have been overruled by the Ninth Circuit, so they are not authoritative.[285] For the most part, authorities addressing exchanges and proximate general transactions are not relevant to exchanges and proximate business transactions because they do not consider transactions that result in a continuation of investment in modified form.[286] Thus, the authority supporting the qualified-use requirement with respect to exchanges that occur in proximity to business transactions is very strong.

#### 2. *Exchanges Before Proximate General Transactions*

The authority is strong for the position that an exchange satisfies the qualified-use requirement if the decision to sell or convert replacement property occurs after the exchange is complete.[287] Exchangers should expect courts to require a showing that something happened after the acquisition of the replacement property that prompted the change in holding purpose.[288] Absent such a showing, a general transaction with respect to the replacement property at the time of the exchange or shortly after it will indicate that the exchanger has not satisfied the qualified-use requirement.[289]

#### 3. *Exchanges After Proximate General Transactions*

Exchanges after proximate general transactions do not qualify for section 1031 nonrecognition if the exchanger has not converted the property from a disqualified use to a qualified use prior to the exchange.[290] Apparently, no section 1031 authority grants section 1031 nonrecognition to an exchanger that successfully converted disqualified-use property to qualified-use property prior to an exchange. Consequently, exchangers must rely upon authority from other areas of the law to determine whether they have successfully converted their property.[291] Such other authority is relevant to the section 1031 qualified-use question, but it does not provide a bright-line rule. Exchangers who want certainty that they have satisfied the qualified-use requirement with respect to residential property can rely upon the safe harbor in Rev. Proc. 2008-16. That safe harbor only applies to dwelling units, so it has limited applicability.

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284. *See supra* note 95 and accompanying text.
285. *See supra* text accompanying notes 44–53.
286. *See supra* Part III.B. (discussing the continued-investment purpose of section 1031 and the business-transaction rules).
287. *See supra* Part IV.B.1(a).
288. *See supra* Part IV.B.1(c).
289. *See supra* Part IV.B.1(b).
290. *See supra* Part IV.B.2(b)(1).
291. *See supra* Part IV.B.2(b)(2).

### 4. *Predicting Outcomes of Common Qualified-Use Exchanges*

The above analysis provides a framework for predicting the outcomes of several types of situations. Figure 10 provides the expected outcome of various situations based upon the relevance, persuasiveness, and type of authority addressing the type of situation.

**Figure 10:**
**Expected Outcomes of the Qualified-Use Requirement of Various Exchanges that Occur in Proximity to Business or General Transactions**

| Situation | Authority | Expected Outcome |
|---|---|---|
| **Exchanges and Proximate Business Transactions** | | |
| Partnership receives rental property from partner contribution and shortly thereafter exchanges it for other property to be held as rental property. | *Bolker*, *Mason*, *124 Front Street* | Satisfy |
| Partner receives rental property from partnership distribution and shortly thereafter exchanges it for other property to be held as rental property. | *Bolker*, *Mason*, *124 Front Street* | Satisfy |
| Exchanger receives replacement property and shortly thereafter contributes it to an LLC. | *Magneson*, *Maloney* | Satisfy |
| Exchanger LLC receives replacement property and shortly thereafter distributes it to one or more members. | *Maloney*, *Magneson* | Satisfy |
| **Exchanges and Proximate General Transactions** | | |
| Exchangers tell qualified intermediary that they want to acquire replacement property for personal use, and they move in a few months after acquisition. | *Regals Realty*, *Black*, *Land Dynamics*, *Starker*, *Click*, *Lindsley*, *Moore*, *Goolsby* | Fail |
| Exchangers acquire replacement property, rent it out for several months, experience a life-changing situation, and then contact CPA about using replacement property as personal residence. | *Reesink* | Satisfy |
| Exchanger, while under contract to acquire property to hold for productive use in a trade or business, receives an offer from someone seeking to acquire the property. Exchanger enters into contract to acquire the property and sell it to offering buyer. Exchanger acquires the property and transfers it to the offering buyer and acquires like-kind replacement property. | *124 Front Street* | Satisfy |

| Figure 10: Expected Outcomes of the Qualified-Use Requirement of Various Exchanges that Occur in Proximity to Business or General Transactions | | |
|---|---|---|
| **Situation** | **Authority** | **Expected Outcome** |
| Taxpayer makes an offer to acquire property. The seller requires taxpayer to acquire like-kind property and transfer it to the seller as consideration for the property. Exchanger acquires the other consideration property and transfers it to the seller in exchange for the property. | *Barker*, Rev. Rul. 77-297 | Fail |
| Several days after acquiring property, exchanger hires a broker to sell it. | *Regals Realty* | Fail |

### B. TRANSACTION TYPE IS THE MOST IMPORTANT FACT

Categorizing and analyzing the various authorities that consider exchanges and proximate business transactions and general transactions reveals that the most important factor in determining whether the exchange will satisfy the qualified-use requirement is the type of transaction. Appendix A lists the qualified-use authorities and shows that when transactions are grouped by type, the tax outcome is almost uniform with respect to each type of transaction. Other factors, such as the holding period and whether ownership spans multiple tax years, do not appear to affect the outcome of the cases.

The category is a relevant factor. The cases that consider exchanges and proximate business transactions rule that the exchange satisfies the qualified-use requirement. Those cases overrule the IRS rulings to the contrary. The type of transaction also is also relevant to the question of whether an exchange satisfies the qualified-use requirement. Appendix A shows that the only factor that appears to correlate positively with the qualified-use requirement is the type of transaction under consideration.

When the qualified-use authorities are presented together based on various factors, they reveal that factors such as holding period and holding property until a subsequent tax year do not affect whether an exchange satisfies the qualified-use requirement. The type of transaction does, however, affect whether the transaction satisfies the qualified-use requirement. When the transactions are grouped together based upon type of transaction, the groupings clearly establish that exchanges in proximity to tax-free business transactions satisfy the qualified-use requirement. The only contrary authorities in that category include: (1) revenue rulings that the Ninth Circuit has overruled; (2) *Regals Realty*, a case in which the exchanger showed an intent to sell replacement property before deciding to contribute it to another corporation; (3) and *Crenshaw*, a disguised-sale case.

If exchangers can show that something happened after acquiring property that caused them to change from holding replacement property for a qualified use to a disqualified use, their exchanges can satisfy the qualified-use requirement. On the other hand, if exchangers use replacement property for a disqualified use after acquisition, in the absence of any evidence that the intent to do so arose after acquisition, they cannot satisfy the qualified-use requirement. Exchangers who intend to convert a dwelling unit to personal use following an exchange can hold the property for two years, satisfy the minimum rental requirements, and limit their use to come within the Rev. Proc. 2008-16 safe harbor.

Contracted-property exchanges satisfy the qualified-use requirement, but cooperative-buyer exchanges do not. The section 1031 authority governing conversions prior to exchanges is unfavorable to exchangers. Exchangers can look to non-section 1031 authority for guidance regarding how they might convert property to a qualified use before exchanging it, or they can satisfy the conditions in Rev. Proc. 2008-16 to obtain certainty regarding the qualified-use requirement if the property is a dwelling unit.

### C. Holding Period Is Mostly Not Relevant

The analysis of the qualified-use authority establishes that the period the exchanger holds exchange property is mostly irrelevant to the qualified-use requirement.[292] The authority definitively establishes there is no two-year holding-period requirement, and holding property over multiple tax years does not affect the application of the qualified-use requirement.

#### 1. *No Two-Year Holding-Period Requirement*

A two-year holding period has no relevance to the qualified-use requirement outside the safe harbor in Rev. Proc. 2008-16. Thus, a two-year holding period only provided comfort with respect to the qualified-use requirement if the exchange property is a dwelling unit that the exchanger rents out for the minimum required days in Rev. Proc. 2008-16. Outside of that safe harbor, no inference can be drawn about the holding period strengthening an exchanger's position regarding the qualified-use requirement. Among the properties considered by the qualified-use requirement, the two held for the longest periods (the *Neal T. Baker* relinquished property (132 months) and the *Moore* relinquished property (144 months)) did not satisfy the qualified-use requirement. Exchanges in

292. As part of legislation proposed in 1989, the House considered adding a rule to section 1031 that would require exchangers to hold exchange property for at least one year to satisfy the qualified-use requirement, but it did not enact that change. *See* H.R. REP. NO. 101-247, at 2810 (Sept. 20, 1989) (proposing the one-year holding requirement); H.R. REP. NO. 101-386, at 614 (Nov. 21, 1989) (Conf. Rep.) (omitting the proposal). Congress's rejection of such an amendment after considering it reinforces the weight of the authority of the judicial opinions that do not require property to be held for any period to satisfy the qualified-use requirement.

proximity to business transactions satisfy the qualified-use requirement even though the exchanger acquires and transfers property on the same day. With respect to general transactions, factors other than the holding period, such as evidence of a change in circumstances, help establish whether the exchanger satisfies the qualified-use requirement. Holding periods for favorable rulings are comparable to holding periods for unfavorable rulings.

#### 2. *No Next-Year Benefit*

Claiming that holding property until a subsequent tax year appears to have no effect on determining whether an exchange satisfies the qualified-use requirement. Exchangers in ten cases held property during at least two tax years (*Regals Realty*, *Maloney*, *Reesink*, *Black*, *Land Dynamics*, *Click*, *Moore*, *Goolsby*, *124 Front Street*, and *Neal T. Baker*). The exchanges satisfied the qualified-use requirement in only three of those cases (*Maloney*, *Reesink*, *124 Front Street*). These results show there is no support in case law for advising a client to hold exchange property at least until a subsequent tax year before transferring it or converting it to a disqualified use. In fact, relying solely on the number of cases that have considered exchanges of property held during multiple tax years, one would conclude that holding property during multiple tax years indicates that the exchanger cannot satisfy the qualified-use requirement with respect to the property. Such a conclusion is, of course, ridiculous, but the cases illustrate that holding property during multiple tax years is irrelevant to the qualified-use analysis.

#### 3. *Advice Prohibited under Rules Governing Tax Practice*

The rules governing tax practice prohibit advisors from giving advice with respect to the likelihood that a transaction will not be audited or that an issue will not be raised on audit.[293] Some advisors may believe that holding exchange property for two years or until a subsequent taxable year will decrease the likelihood that the exchange will be audited or that the qualified-use requirement will be raised on audit.[294] Because such advice relates to the likelihood that a return will not be audited or that a matter will not be raised on audit, the rules governing the provision of tax advice prohibit such advice.

293. Treas. Reg. § 1.6662-4(d)(2); Circular 230: Regulations Governing Practice Before the Internal Revenue Service, 31 C.F.R. § 10.37(a)(2)(vi) (June 12, 2014) [hereinafter Circular 230].

294. *See, e.g.*, *How Long Do You Have to Hold Property in a 1031 Exchange?*, REALIZED (Nov. 29, 2023), https://www.realized1031.com/blog/how-long-do-you-have-to-hold-property-in-a-1031-exchange ("[T]here is no minimum holding period for a 1031 exchange property, but the IRS and many advisors recommend holding it for at least two years to avoid scrutiny.").

#### 4. *No Reporting-Position Equivalent for a Holding-Period Requirement*

The weight of authority supporting a reporting position must provide at least a reasonable basis that the position will be upheld for a tax practitioner to advise a client to take the reporting position.[295] The holding period is only relevant to the qualified-use requirement in two situations: (1) if the exchange property is a dwelling unit that can satisfy the conditions of the safe harbor in Rev. Proc. 2008-16 or (2) if something happens in the period after property is acquired and when it is converted to a disqualified use that shows a change in intent. There is no minimum required time period for the latter type of exchange. Because there is no authority outside of those two situations that indicate the period of time exchange property is held, there is no reasonable basis for the position that holding property for a given period of time or until a subsequent tax year will increase the likelihood that the qualified-use requirement will be upheld. Thus, outside of those two situations, there is no reporting-position equivalent for advising a client that holding exchange property for a longer period of time will increase the likelihood that the qualified-use requirement will be upheld. A thought experiment helps illustrate this phenomenon, and then a potential real-life situation brings the issue into focus.

##### (a) Holding-Period Thought Experiment

A relatively simple, although perhaps unlikely, thought experiment helps test the claim that there is insufficient authority to support a claim that a longer holding period will increase the likelihood that the qualified-use requirement will be upheld. To illustrate, consider a situation in which an exchanger would like to recognize loss but may be prohibited from doing so by section 1031. Assume the members of a limited liability company decide to structure the disposition of the limited liability company's only asset as an at-closing drop-and-swap. Pursuant to their plan, the members cause the limited liability company to negotiate the sale of the property and contract to sell it under the direction of the members. Undivided interests in the property are deeded to the members on the day of closing, and the members transfer their respective interests in the property to the buyer and direct their shares of the sale proceeds to go to their respective qualified intermediaries (the members individually enter into exchange agreements with the qualified intermediaries of their choosing). The members also entered into a tenancy-in-common agreement to show that they intended to acquire undivided interests in real property. The members complete exchanges by acquiring like-kind replacement property.

295. Circular 230, § 10.34(a)(ii)(A).

When it comes time to file taxes, Zephyr, one of the members, recalls that he had recently received his interest in the limited liability company as an inheritance and that he had a stepped-up basis in that interest, and that basis became his basis in the distributed undivided interest. The basis was greater than the amount Zephyr received on the transfer of the undivided interest to the buyer, so he actually realized a loss on the transfer, but he completed the acquisition of replacement property through his qualified intermediary using his share of the sale proceeds.

Noticing that he could benefit from recognizing the loss realized on the transaction, Zephyr asks for an opinion on whether he can claim the loss. To claim the loss, Zephyr must establish that the transfer of the undivided interest and receipt of replacement property does not qualify for section 1031 nonrecognition. Zephyr probably could have structured his sale and reinvestment to avoid the prospect of the transaction being treated as a section 1031 exchange, but he did not think of doing that until after the transaction closed. Zephyr also failed to notify the person advising him with respect to the drop-and-swap that he had received the interest in the limited liability company through inheritance. Other members realized gain on the transaction and will separately report their transactions as section 1031 exchanges and not recognize the gain. Zephyr's transaction satisfies all of the like-kind requirement, the real-property requirement, and the exchange requirement,[296] so the only question is whether he can claim that his transaction fails the qualified-use requirement with respect to the undivided interest he received from the limited liability company and immediately transferred.

Zephyr has almost no authority to rely upon to claim that the transaction does not satisfy the qualified-use requirement. All the relevant case law that considers the qualified-use requirement with respect to an exchange in proximity to a business transaction supports the qualified-use position. Perhaps Zephyr's advisor would cite Rev. Rul. 77-337 as authority for the position that he cannot satisfy the qualified-use requirement. The IRS would produce *Bolker* to show that Rev. Rul. 77-337 has been overruled and show that it has previously relied upon *Bolker* and implicitly overruled Rev. Rul. 77-337. Because *Bolker* explicitly overruled Rev. Rul. 77-337, the revenue ruling is, at best, very weak supporting authority.[297] Even outside the Ninth Circuit, courts and tax-enforcing authorities are very likely to cite and rely upon *Bolker*, as the U.S. District Court for the Central District of Illinois and the U.S. Justice Department did in *Barker v. United States*.[298]

296. *See supra* Part III.G. (discussing how an exchange in proximity to a business transaction can satisfy these requirements).

297. *See supra* text accompanying notes 41–53.

298. *See* Barker v. United States, 668 F. Supp. 1199, 1202 (C.D. Ill. 1987); Borden, *Tax-Law Analysis*, *supra* note 14, at 397–98.

This hypothetical raises the question of whether the IRS would be estopped from taking a position contrary to Rev. Rul. 77-337. Typically, courts will not allow the IRS to argue principles contrary to those in public guidance, such as a revenue ruling.[299] This hypothetical is not typical, however, because the revenue ruling at issue has been overruled by the Tax Court and the Ninth Circuit.[300] Because Rev. Rul. 77-337 has been overruled, whether the IRS would be estopped from taking a position contrary to it is an open question. Based upon its own regulations, the IRS would be able to claim Rev. Rul. 77-337 is no longer authority because it has explicitly or implicitly been overruled.[301] Thus, it could distinguish this situation from other situations in which it was bound by its prior guidance. Furthermore, Zephyr received a distribution from an entity taxed as a partnership, and Rev. Rul. 77-337 applied to a distribution from a corporation. The IRS might be successful in distinguishing the facts from the ruling and be able to argue that the qualified-use requirement is satisfied despite the principles it expressed in the revenue ruling. Consequently, the ruling would not appear to provide strong support for Zephyr.

No authority would support a claim that Zephyr failed to satisfy the qualified-use requirement because he did not hold the distributed property for two years (or some other minimum period of time because the authority does not establish a minimum holding-period requirement) or because he did not hold it until the subsequent taxable year. With the authority overwhelmingly supporting the qualified-use requirement, Zephyr would not appear to have a reasonable basis for claiming this transaction does not satisfy the qualified-use requirement, so the advisor probably cannot issue an opinion supporting Zephyr's claiming a loss on the transaction.

#### (b) Exposure to Transaction Risk

The Zephyr thought experiment establishes that an advisor probably could issue an opinion that an exchange in proximity to a business transaction fails to satisfy the qualified-use requirement if the exchanger does not hold the property for the required period of time. Because there is no authority supporting a holding-period requirement for exchanges in proximity to business transactions, advisors should also consider how any advice to hold property for a period of time can raise non-tax risks.

Advisors who are unfamiliar with the authority governing the qualified-use requirement may conclude that advising exchangers to hold property for some period of time will reduce the likelihood that an exchange will be denied section 1031 nonrecognition. Thus, out of an abundance of caution,

299. Rauenhorst v. Comm'r, 110 T.C. 157, 170–71 (2002); Borden, *Tax-Law Analysis*, *supra* note 14, at 393–94.

300. *See supra* text accompanying notes 52–53.

301. Treas. Reg. § 1.6662-4(d)(3)(iii); Borden, *Tax-Law Analysis*, *supra* note 14, at 393–94.

such advisors may tell clients to hold exchange property for two years or at least until the subsequent tax year. The thinking may be that such a practice reduces the risk of losing the benefits of section 1031, i.e., holding the property longer reduces the tax risk.

Tax risk is only one risk that an exchanger should consider when deciding whether to extend the holding period of a property. The non-tax risks of holding property can also be quite significant. The following example helps illustrate such non-tax risks. Saet-byeol and Dae-hyeon are equal partners in a partnership. The partnership receives an offer from a buyer wishing to purchase the partnership's sole asset, a piece of real property, and Saet-byeol and Dae-hyeon decide to sell the property. Saet-byeol and Dae-hyeon also decide to go their separate ways as part of the disposition, each wanting to separately complete a section 1031 exchange. The qualified intermediary to which Saet-byeol reaches out to facilitate her exchange advises Saet-byeol that if she receives an undivided interest in the property and transfers it, she cannot do a section 1031 exchange because she needs to hold the distributed interest until at least the subsequent tax year. The qualified intermediary informs Saet-byeol that to qualify for section 1031 treatment, the partnership should sell the relinquished property, acquire two replacement properties, wait two years following the acquisition of the two properties, and then divide by distributing one replacement property to Saet-byeol and one to Dae-hyeon. The parties follow this advice, and the partnership acquires two properties. Saet-byeol and Dae-hyeon each chose a property the partnership acquired, and they plan to distribute the properties to the partner that chose it.

Twenty-two months following the acquisition of the two replacement properties, Saet-byeol and Dae-hyeon meet to discuss the division of the partnership. The property that Saet-byeol chose has done very well and significantly increased in value. The property Dae-hyeon chose has not done well and is now worth much less than what the partnership paid for it. The partners discuss how they might divide the partnership and seem inclined to stick with their original plan of distributing the properties to the partners according to their original choice. The partners leave that meeting, and on the way home, Dae-hyeon is killed in a car accident. His heirs do not like the idea of receiving the property Dae-hyeon is alleged to have chosen, and they want an equal share of the partnership's value. The partners incur significant legal fees to liquidate the partnership, and Saet-byeol receives a distribution that is several million dollars less than the value of the property she had chosen for the partnership to acquire.

#### (c) Exposure to Advisory Risk

In addition to being aware of the tax and transaction risks that exchangers must consider, advisors should also take into account their own advisory

risks. Some advisors may conclude that they reduce their advisory risk by giving advice that reduces tax risk, but that is not necessarily the case.

Saet-byeol searches on Google for any sources she might be able to tap into to cover the losses she believes she incurred as a result of the transaction the partnership entered. She learns that there is a Ninth Circuit court case and a Tax Court case that say an exchange immediately following a distribution of property can satisfy the qualified-use requirement. She also learns that holding property for two years after an exchange before distributing it from a partnership does not increase the likelihood that the partnership's exchange will satisfy the qualified-use requirement.

If Saet-byeol claims that she relied upon the qualified intermediary's advice to have the partnership complete the exchange and hold the property for two years, the qualified intermediary will be hard-pressed to find support for the advice it gave. One defense might be that the transaction, Dae-hyeon, and the partnership were outside the Ninth Circuit, so *Bolker* does not provide significant authority for doing an exchange immediately after a distribution. That defense is likely to be unconvincing because courts rely upon decisions in other circuits,[302] and the Tax Court has granted section 1031 nonrecognition to a transfer of property that occurred simultaneously with a distribution.[303] By advising Saet-byeol to do something that the law does not require, the qualified intermediary has opened itself to advisory risk.

The parade of horribles that may occur while exchangers or entities of which exchangers are members hold property to satisfy a nonexistent holding requirement are numerous and can be quite significant. Advisors cannot expect to be protected from advisory liability if they advise clients to take what they deem to be a conservative tax-reporting position because tax risk is only one type of risk that exchangers must consider. If the advice an advisor provides, even though it is deemed to provide a conservative reporting position, creates non-tax risks, the advisor could be liable for non-tax costs that arise from that advice. Advisors should account for their own risks when giving advice. Because the weight of authority supports a no-holding-period requirement with respect to exchanges in proximity to tax-free business transactions, advisory risk is lowest for advisors who provide such advice. No advisor should be liable for providing such advice because the authorities overwhelmingly support it. Tax advisors and their clients are best served when the advisors base their advice on the weight of authority as prescribed in the rules governing tax practice.[304]

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302. *See* Borden, *Tax-Law Analysis*, *supra* note 14, at 396–98.

303. Mason v. Comm'r, 55 T.C.M. (CCH) 1134 (1988); *see supra* text accompanying notes 47–50.

304. *See* Borden, *Tax-Law Analysis*, *supra* note 14, at 391–400.

#### 5. *Longer Holding Period Can Increase Tax Risk*

Case law suggests that, with respect to exchanges and proximate business transactions, holding property for a period can increase the risk that the property will lose its qualified-use status. For instance, *Regals Realty* was an exchange followed by a contribution to a corporation.[305] The exchanger held the property for just five months, and the holding period spanned two tax years, but the court found that the exchanger acquired the property with the intent to sell it.[306] The basis of the court's holding was the exchanger's decision to offer the property for sale after its acquisition.[307] If the exchanger had acquired the property and immediately contributed it, the general rule presented in *Maloney* would have applied,[308] and the transaction likely would have satisfied the qualified-use requirement.[309]

If an exchanger decides to place time between an exchange and a proximate business transaction, such time can create tax risk if the exchanger communicates an interest in selling the property or converting it to disqualified use during that holding period. For instance, assume an exchanger acquires property and decides to hold it for some period prior to contributing it to a limited liability company to be developed. During that period, the exchanger explores other alternatives, including selling the property. Emails between the exchanger and their broker could become evidence that the exchanger had changed its intent to sell the property. The exchanger avoids that risk by immediately contributing the property to the limited liability company.

A longer holding period can particularly increase tax risks related to property to be held by an exchanger in an arrangement intended to be a tenancy-in-common. The longer the property is held in such a structure, the greater the likelihood that something about the arrangement will cause the arrangement to be a TICnership.[310] For instance, the co-owners may deem it necessary to give a manager a long-term contract, they may increase the level of services provided by the co-owners or manager, or alter the profit-sharing arrangement, any one of which can cause the arrangement to become a TICnership.[311] The risks of the arrangement becoming a TICnership can be

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305. Regals Realty Co. v. Comm'r, 127 F.2d 931, 933 (2d Cir. 1942); *supra* text accompanying notes 95, 182.

306. *Regals Realty*, 127 F.2d at 933.

307. *Id.* at 934.

308. Maloney v. Comm'r, 93 T.C. 89, 98 (1989); Bolker v. Comm'r, 81 T.C. 782, 805 (1983), *aff'd* 760 F.2d 1039, 1045 (9th Cir. 1985) ("A trade of *property A* for *property B*, both of like kind, may be preceded by a tax-free acquisition of *property A* at the front end, or succeeded by a tax-free transfer of *property B* at the back end."); *see supra* text accompanying note 38.

309. *Maloney* was decided after *Regals Realty*, but the rule it espouses has been applied consistently by the courts, so there is no reason to believe the courts would have reached a different decision at a different time. *See supra* Part III.A.

310. *See* Borden, *TICnerships supra* note 6, at 607–08, 680–81 (discussing TICnerships).

311. *See id.* at 622–31.

minimized by decreasing the holding period of the arrangement. The IRS recognizes transitory ownership (i.e., ownership that lasts for a very short time) of interests in property in various contexts,[312] so it should recognize the ownership of undivided interests in property when such ownership is designed to be transitory as part of an exchange in proximity to a business transaction.

### D. An Off-Point, Old Private Letter Ruling is a Bad Guidepost

A prominent qualified intermediary recently reported that "[s]ome tax advisors look to [P.L.R.] 8429039 as a guidepost, in which the IRS stated that a holding period of two years would be a 'sufficient' period of time for the property to be considered held for investment."[313] Relying upon that P.L.R. for that position is folly. First, the private letter ruling is more than ten years old, so it is accorded very little weight.[314] Second, the P.L.R. does not say that holding property for two years will be a sufficient period for the property to be considered as held for investment.[315] The facts under consideration in the P.L.R. were that the exchanger represented to hold the replacement property "for productive use in a trade or business or for investment for a period not less than two years from and after the exchange."[316] The period for which the exchanger held the property is not part of the facts. If the exchanger's situation changed shortly after acquiring the property, the exchanger could have transferred the property or converted its use without

312. *See, e.g.*, Rev. Rul. 99-5, 1999-1 C.B. 434; Treas. Reg. § 1.708-1(c)(3)(ii) ("Despite the partners' transitory ownership of the terminated partnership's assets, the form of a partnership merger or consolidation will be respected for Federal income tax purposes if the merged or consolidated partnership that is considered terminated . . . distributes all of its assets to its partners (in a manner that causes the partners to be treated, under the laws of the applicable jurisdiction, as the owners of such assets) in liquidation of the partners' interests in the terminated partnership, and immediately thereafter, the partners in the terminated partnership contribute the distributed assets to the resulting partnership in exchange for interests in the resulting partnership."), -1(d)(3)(ii)(A) ("Despite the partners' transitory ownership of some of the prior partnership's assets, the form of a partnership division will be respected for Federal income tax purposes if the divided partnership . . . distributes certain assets (in a manner that causes the partners to be treated, under the laws of the applicable jurisdiction, as the owners of such assets) to some or all of its partners in partial or complete liquidation of the partners' interests in the divided partnership, and immediately thereafter, such partners contribute the distributed assets to a recipient partnership or partnerships in exchange for interests in such recipient partnership or partner"); Treas. Reg. § 301.7701-3(g)(1) ("If an eligible entity classified as an association elects . . . to be classified as a partnership, the following is deemed to occur: The association distributes all of its assets and liabilities to its shareholders in liquidation of the association, and immediately thereafter, the shareholders contribute all of the distributed assets and liabilities to a newly formed partnership.").

313. *The 1031 Exchange Qualified Use Requirement and Importance of Intent—Is Time a Factor?*, *supra* note 19.

314. Treas. Reg. § 1.6662-4(d)(3)(ii).

315. I.R.S. Priv. Ltr. Rul. 84-29-039 (Apr. 17, 1984).

316. *Id.*

losing the qualified-use determination.[317] Third, private letter rulings have no precedential value.[318] Fourth, other types of authority clearly establish that the qualified-use requirement does not include a two-year-holding-period requirement (outside the conditions in Rev. Proc. 2008-16) or that holding property for two years helps establish that the qualified-use requirement has been satisfied.[319] Fifth, the circumstances surrounding P.L.R. 8429039 are suspicious. The P.L.R. was issued after the IRS issued an adverse private letter ruling to the same exchanger in 1982 because the exchanger intended to sell the replacement property soon after its acquisition.[320] One wonders if the exchanger and the IRS consulted to determine what time period the IRS was willing to accept. Whether the IRS would have been willing to issue a ruling based upon a shorter time period is not publicly known. For instance, if it had been willing to issue the same ruling if the exchanger had represented that it would hold the replacement property for at least eight months, then the two-year period is meaningless. Sixth, the benefits to be gained from completing an exchange and then immediately disposing of the replacement property typically would not be significant. There are two exceptions to this general rule: (1) if the sale occurs in a year following the acquisition, the gain can be deferred to the subsequent year of the sale; and (2) an exchange from section 1250 property into raw land might eliminate unrecaptured section 1250 gain.[321]

In short, there is no basis for looking to P.L.R. 8429030 as a guidepost for a two-year holding-period requirement or for using it to claim that holding property for two years strengthens an exchanger's qualified-use position. If the advisor described in the hypothetical above presented P.L.R. 8429039 as a defense for advising Saet-byeol that the partnership needs to hold the property for two years to satisfy the qualified-use requirement, it would most likely diminish its credibility because there is no basis for relying upon that P.L.R. for giving such advice.[322]

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317. *See, e.g.*, Reesink v. Comm'r, 103 T.C.M. (CCH) 1647 (2012) (holding that an exchanger who converted property to personal use within eight months after acquiring it satisfied the qualified-use requirement).

318. I.R.C. § 6110(j); I.R.S. Priv. Ltr. Rul. 84-29-039 (Apr. 17, 1984).

319. *See supra* Parts III.A, IV.

320. Presumably, the private letter ruling issued in 1982 was I.R.S. Priv. Ltr. Rul. 83-10-016 (Dec. 1, 1982).

321. Bradley T. Borden, *Navigating the Confluence of Code Secs. 1031 and 1250*, J. PASSTHROUGH ENT., May–June 2016, at 25, 27 ("Because Code Sec. 1250(a) only applies to section 1250 property, presumably the unrecognized unrecaptured section 1250 gain would only carry over to section 1250 replacement property.") Section 1250 property must be subject to the allowance for depreciation. I.R.C. § 1250(c). Raw land is not subject to the allowance for depreciation. Treas. Reg. § 1.167(a)-2.

322. If an advisor could rely upon I.R.S. Priv. Ltr. Rul. 84-29-039 to give advice, the advice would have to be along these lines: "The IRS has privately ruled that if an exchanger intends to hold replacement property for two years after acquisition for productive use in a trade or business or for investment, the exchanger can satisfy the qualified use requirement." Given such advice, the exchanger may consider documenting such an intent, but the exchanger's subsequent actions,

## VI. CONCLUSION

The rules governing the section 1031 qualified-use requirement are well established and clear with respect to exchanges and proximate business transactions. Those rules provide, as a matter of law, that an exchange in proximity to a business transaction satisfies the qualified-use requirement if the exchanger entity holds the property for qualified use and the exchanger does not have a disqualified-use holding intent for the period it holds the exchange property between the exchange and business transaction. If property held by an entity moves in a circular way out of and then back into the entity, the courts can recast such a transaction as a disguised sale of an interest in the entity.

The law governing exchanges in proximity to general transactions is certain with respect to contracted-property exchanges (can satisfy the qualified-use requirement) and cooperative-buyer exchanges (do not satisfy the qualified-use requirement). The law is also certain with respect to conversions of replacement property to disqualified use following an exchange (can satisfy the qualified-use requirement) and with respect to acquisitions of property intended to be used for a disqualified use (do not satisfy the qualified-use requirement). Finally, exchangers must successfully convert property from disqualified use to qualified use prior to an exchange for the exchange to satisfy the qualified-use requirement. Multiple cases find that exchangers have failed to meet that requirement. In the absence of section 1031 authority showing what constitutes a successful conversion to a qualified use, exchangers may look to cases in other areas of the law that consider holding intent. Often, such authority is not definitive, so exchangers may instead look to the safe harbor in Rev. Proc. 2008-16 to be certain that a dwelling unit that is used for personal pursuits can satisfy the qualified-use requirement. Beyond that limited scope, the revenue procedure has no application to the qualified-use requirement.

Advisors must use caution when giving advice regarding the qualified-use requirement that is not supported by authority. An advisor's perception of tax risk should not drive the advice. Exchangers must consider the tax risk of a reporting position along with other risks that a transaction may raise. Advisors need to give accurate advice regarding the authorities governing the qualified-use requirement. Such accuracy can only be reached by considering the relevance, persuasiveness, and type of authority that addresses the qualified-use requirement.

changes to the situation, and case law would determine whether the exchanger satisfies the qualified-use requirement.

## APPENDIX A: TABLE OF QUALIFIED-USE AUTHORITIES

| | Case Name | Year | Authority | Cite | Qual'd Use | Holding Period (Months) | Two Tax Years | Weight of Authority |
|---|---|---|---|---|---|---|---|---|
| **Exchanges and Proximate Business Transactions** | | | | | | | | |
| **Exchange Before Contribution** | | | | | | | | |
| 1 | Regals Realty v. Comm'r (1) | 1942 | 2d Cir. | 127 F.2d 931 | No | 5 | X | Weak contrary |
| 2 | Rev. Rul. 75-292 | 1975 | IRS | 1975-2 C.B. 333 | No | 0 | | Weak/ Not authority |
| 3 | Magneson v. Comm'r | 1985 | 9th Cir. | 753 F.2d 1490 | Yes | 0 | | Very strong supporting |
| **Exchange Before Distribution** | | | | | | | | |
| 4 | Maloney v. Comm'r | 1989 | Tax Court | 93 T.C. 89 | Yes | 0.13 | X | Very strong supporting |
| **Exchange After Distribution** | | | | | | | | |
| 5 | Rev. Rul. 77-337 | 1977 | IRS | 1977-2 C.B. 305 | No | 0 | | Weak/ Not authority |
| 6 | Bolker v. Comm'r | 1985 | 9th Cir. | 760 F.2d 1039 | Yes | 3 | | Very strong supporting |
| 7 | Mason v. Comm'r | 1988 | Tax Court | 55 T.C.M. (CCH) 1134 | Yes | 0 | | Strong supporting |
| **Disguised Sale** | | | | | | | | |
| 8 | Crenshaw v. U.S. | 1972 | 5th Cir. | 450 F.2d 472 | No | 0 | | Strong contrary |
| **Exchanges and Proximate General Transactions** | | | | | | | | |
| **Exchanges before general transactions** | | | | | | | | |
| **Change of intent following exchange** | | | | | | | | |
| 1 | Rev. Rul. 57-244 | 1957 | IRS | 1957-1 C.B. 247 | Yes | 0 | | Strong Favorable |
| 2 | Priv. Ltr. Rul. 8429039 | 1984 | IRS | | Yes | | | Weak supporting |
| 3 | Wagensen v. Comm'r | 1980 | Tax Court | 74 T.C. 653 | Yes | 9 | | Very strong supporting |
| 4 | Reesink v. Comm'r | 2012 | Tax Court | 103 T.C.M. (CCH) 164 | Yes | 8 | X | Strong supporting |

| | Case Name | Year | Authority | Cite | Qual'd Use | Holding Period (Months) | Two Tax Years | Weight of Authority |
|---|---|---|---|---|---|---|---|---|
| **Disqualified intent at time of exchange** | | | | | | | | |
| 5 | Regals Realty v. Comm'r (2) | 1942 | 2d Cir. | 127 F.2d 931 | No | 5 | X | Strong contrary |
| 6 | Black v. Comm'r | 1960 | Tax Court | 35 T.C. 90 | No | 8 | X | Strong contrary |
| 7 | Land Dynamics v. Comm'r | 1978 | Tax Court | 37 T.C.M. (CCH) 1119 | No | 10 –21 | X | Strong contrary |
| 8 | Starker v. U.S. | 1979 | 9th Cir. | 602 F.2d 1341 | No | 0 | | Strong contrary |
| 9 | Click v. Comm'r | 1982 | Tax Court | 78 T.C. 225 | No | 7 | X | Strong contrary |
| 10 | Lindsley v. Comm'r | 1983 | Tax Court | 47 T.C.M. (CCH) 540 | No | 0.25 | | Strong contrary |
| 11 | Priv. Ltr. Rul. 8310016 | 1983 | IRS | | No | 0 | | Weak contrary |
| 12 | Moore v. Comm'r (1) | 2007 | Tax Court | 93 T.C.M. (CCH) 1275 | No | 0 | X | Strong contrary |
| 13 | Goolsby v. Comm'r | 2010 | Tax Court | 99 T.C.M. (CCH) 1249 | No | 2 | X | Strong contrary |
| **Exchange after general transaction** | | | | | | | | |
| **Contracted-Property Exchange** | | | | | | | | |
| 14 | 124 Front Street v. Comm'r | 1975 | Tax Court | 65 T.C. 6 | Yes | 6 | X | Strong supporting |
| **Cooperative-Buyer Exchange** | | | | | | | | |
| 15 | Rev. Rul. 77-297 | 1977 | IRS | 1977-2 C.B. 304 | No | 0 | | Strong contrary |
| 16 | Rutherford v. Comm'r | 1978 | Tax Court | 37 T.C.M. (CCH) 1851-77 | Yes | 3 | | Weak supporting |
| 17 | Barker v. U.S. | 1987 | C.D. Ill. | 668 F.Supp. 1199 | No | 0 | | Strong contrary |

| | Case Name | Year | Authority | Cite | Qual'd Use | Holding Period (Months) | Two Tax Years | Weight of Authority |
|---|---|---|---|---|---|---|---|---|
| **Failure to Convert Purpose** | | | | | | | | |
| 18 | Neal T. Baker Enters. v. Comm'r | 1998 | Tax Court | 76 T.C.M. (CCH) 301 | No | 132 | X | Strong contrary |
| 19 | Moore v. Comm'r (2) | 2007 | Tax Court | 93 T.C.M. (CCH) 1275 | No | 144 | X | Strong contrary |