Impose Capital Gains Tax on Like-Kind Exchanges

By Calvin H. Johnson

Calvin H. Johnson is professor of law at the University of Texas. The author wishes to thank Alice Abreu, Charles Davenport, Erik Jensen, Marjorie Kornhauser, Daniel Simmons, and Larry Zelenak for helpful comments on a prior draft, without however, implicating them in conclusions with which they disagree.

The proposal would repeal nonrecognition of gain that current law allows for like-kind exchanges. Nonrecognition was first adopted to avoid the difficulties of valuation, but under modern broker transactions, valuation is not a difficult determination. Most gain not recognized in an exchange is never taxed. The reasons why Congress took stock and bonds out of eligibility for nonrecognition, moreover, apply to real estate as well. Real estate should not be favored over competing investments. Given revenue needs, taxing like-kind exchanges can help ease current budget difficulties.

The proposal is made as a part of the Shelf Project, a collaboration by tax professionals to develop and perfect proposals to help Congress when it needs to raise revenue. Shelf Project proposals are intended to raise revenue, defend the tax base, follow the money, and improve the rationality and efficiency of the tax system. The tax community can propose, follow, or edit proposals at http://www.taxshelf.org. A longer description of the Shelf Project can be found at ''The Shelf Project: Revenue-Raising Projects That Defend the Tax Base,'' *Tax Notes*, Dec. 10, 2007, p. 1077, *Doc 2007-22632*, *2007 TNT 238-37*.

Shelf Project proposals follow the format of a congressional tax committee report in explaining current law, what is wrong with it, and how to fix it.

Current law allows a taxpayer to avoid taxation of gain on a disposition of real estate to the extent the taxpayer is willing to acquire other real estate as a replacement. The proposal would repeal section 1031 regarding gain and require an exchange broker to file an information return showing the amount realized by the taxpayer. Valuation is not a problem when the purchaser gives the cash price to an intermediary hired for the transaction or when the intermediary or purchaser buys replacement property for the purpose of the exchange. Section 1031 does not now apply to stock turnovers, and tax rates on stock should be lower than tax rates on land.[1]

A. Current Law

Section 1031 provides that there will be no recognition of gain when business or investment property is exchanged for like-kind property that will also be used for business or investment. Property not eligible for nonrecognition includes personal-use property like homes and cars, inventory held for sale to customers, stock and debt securities, interests in partnerships and trusts, and legal claims.[2] With the exclusions, the major focus of section 1031 is on swaps involving real estate, although exchanges of personal property such as trade-ins of machinery and equipment do occur.

The like-kind requirement refers to the legal character of the property, primarily whether the property is real property or personal property under governing state law. Within real property, the properties exchanged can be quite dissimilar. A city high-rise apartment building, for instance, is considered to be of like kind with unimproved rural investment land, a ranch or farm, a lease of greater than 30 years, or an interest in oil, gas, and other minerals.[3] Like kind is said not to be intended ''to draw any distinction between parcels of real property, however dissimilar they may be in location, in attributes, and in capacities for profitable use.''[4] Personal property, as defined by state law, is not of like kind with real property. Thus an exchange of land for the right to cut timber, for the right to extract gravel, and for short-term leases will require recognition of the gain on the transferred land.[5] Trade-ins of used for new machinery are of like kind because both the old and new machinery are personal

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[1]Analyses especially valuable to this project include Marjorie Kornhauser, ''Section 1031: We Don't Need Another Hero,'' 60 *S. Cal. L. Rev*. 397 (1986); and Richard Schmalbeck and Lawrence Zelenak, *Federal Income Taxation*, 303-324 (2004).

[2]Section 1031(a)(2).

[3]*Commissioner v. Crichton*, 122 F.2d 181 (5th Cir. 1941) (oil and gas rights received); *Koch v. Commissioner*, 71 T.C. 54 (1978) (land for long-term lease); reg. section 1.1031(a)-1(c) (1991) (city real estate for farm or ranch or lease of over 30 years).

[4]*Commissioner v. Crichton*, 122 F.2d at 182; reg. section 1.1031(a)-1(b) and (c).

[5]*Peabody National Resources Co. v. Commissioner*, 126 T.C. 261 (2006) (land was not of like kind to timber cutting rights); *Commissioner v. P.G. Lake, Inc*., 356 U.S. 260 (1958) (land was not of like kind to oil-production-payment carve out of set dollars); *Clemente, Inc. v. Commissioner*, T.C. Memo. 1985-367 (land was not of like kind to gravel extraction rights); *Capri, Inc. v. Commissioner*, 65 T.C. 162, 181 (1975) (land was not of like kind to short-term lease).

property. There is no recapture of prior depreciation in the exchange, unless the taxpayer receives taxable boot.[6]

Like-kind exchanges anticipate that the taxpayer will remain invested in like-kind replacement property. The taxpayer is, accordingly, required to recognize gain on transferred real estate if boot is received in return. Boot includes both cash and ineligible property. Gain is recognized to the extent of the boot. For example, if a taxpayer transfers real estate with a built-in gain of $20x and receives back both like-kind real estate and cash of $30x, the taxpayer will pay tax on the full $20x gain.[7] Assumption of the taxpayer's liability in the transaction is treated as boot, but only after subtracting liabilities the taxpayer assumes in return.[8]

Congress seems to have thought that it was dealing with small informal barters — ''thousands of horse trades and similar barter transactions.''[9] Modern like-kind real estate exchanges, however, are almost all brokered triangular transactions in which the exchange is a staged event between the taxpayer and a hired intermediary (broker) who uses newly purchased replacement property. In a triangular exchange, a purchaser willing to pay the taxpayer cash for the property transfers the cash to the intermediary broker the taxpayer has hired. The broker buys property the taxpayer has identified as a suitable replacement for the property given up using the purchaser's cash. There is a staged exchange in which the taxpayer gives up the property to be sold and receives the replacement property. The broker finishes by transferring the property the taxpayer has given up to the cash purchaser.[10] The primary function of the broker is to keep the available cash out of the hands of the taxpayer so that he will not receive and be taxed on the cash.

In theory, the transaction could be done without the intermediary if the purchaser would buy the replacement property the taxpayer has identified and then go into the staged exchange. There is, however, a nationwide industry of commercial intermediaries specializing in the transactions and most tax lawyers can do it. The purchasers rarely find it necessary to get involved in the replacement after paying their cash.[11]

Exchanges no longer need to be simultaneous. The purchaser can pay the cash purchase price to the broker and get the property immediately. The transaction will qualify as a like-kind exchange as long as the taxpayer identifies replacement property within 45 days and receives the replacement property from the broker within 180 days.[12] In a reverse-deferred exchange, a taxpayer can also receive the replacement property first, and decide later what property among the taxpayer's portfolio will be given up in exchange, as long as the identification takes place within 45 days and the broker does not hold the property for more than 180 days.[13]

With the broad definition of like kind, and the settled availability of broker exchanges and nonsimultaneous exchanges, taxpayers can achieve nonrecognition on a sale of real estate to a purchaser who has paid cash for the property if they are willing to keep the purchaser's cash invested in real estate.

In theory, a like-kind exchange is a deferral of tax until the replacement property is sold, and not a forgiveness of tax. Section 1031(d) requires basis calculations for the replacement property such that gain built into the property given up will remain in the replacement property, unless recognized in the transaction itself. In reality, however, most realized gain that is not taxed in the transaction is never taxed. Economists estimate that only between 20 percent of unrecognized gain[14] and 46 percent of unrecognized gain[15] will be taxed eventually. Most of the unrecognized gain disappears because section 1014 provides for a step-up in basis for property received by reason of death of the prior owner. Taxpayers avoid recognition of net gain that is built into the replacement property until death. Basis rules, moreover, are not well enforced and the section 1031(d) rules are hard for laymen to understand.[16] Even for tax that is paid eventually, the deferral reduces its net present value. The

[6]Section 1245(b)(4).

[7]Reg. section 1.1031(d)-1 (1967).

[8]Reg. section 1.1031(d)-2 (1956).

[9]House Ways and Means Committee, H. Rep. No. 704, 73d Cong., 2d Sess. (1934), reprinted in 1939-1 (Part 2) C.B. 554, 564.

[10]Examples of triangular exchanges include *Alderson v. Commissioner*, 317 F.2d 790 (9th Cir. 1963); *Barker v. Commissioner*, 74 T.C. 555 (1980); *Biggs v. Commissioner*, 69 T.C. 905 (1979).

[11]Indeed, Schmalbeck and Zelenak, *supra* note 1, at 311 (2004), argue, ''Part of the explanation for the current state of the law is that some influential people make a nice living helping taxpayers jump through the triangular exchange hoops, and those people would have to find something else to do if Congress rationalized the law.''

[12]Section 1031(a)(3).

[13]Rev. Proc. 2000-37, 2000-2 C.B. 308, *Doc 2000-24091*, *2000 TNT 181-13*.

[14]Jane G. Gravelle, ''Limit to Capital Gains Feedback Effects,'' Congressional Research Service Report for Congress at 4 (1991) (taking out timber, housing, and nonprofit results and finding that 46 percent of accrued gains are realized); but see prior work, Jane G. Gravelle and Lawrence B. Lindsey, ''Capital Gains,'' *Tax Notes*, Jan. 25, 1988, p. 397 (76 percent of capital gains are held until death, so only 24 percent are eventually recognized).

[15]Laurence Kotlikoff, ''Intergenerational Transfers and Savings,'' 2 *J. of Econ. Persp*. 41, 43 (Spring 1988); Laurence Kotlikoff and Lawrence Summers, ''The Role of Intergenerational Transfers in Aggregate Capital Accumulations,'' 89 *J. of Pol. Econ*. 706 (1981) (estimating that once savings arise, 80 percent is held until death). If 80 percent of all wealth is held until death, then we should expect wealth at death to be especially rich in unrealized gain, given the incentives to hold high-gain property and rely on loss or low-gain property to support standard of living. Kotlikoff's measures would thus support a finding that less than 20 percent of unrealized gain is taxed.

[16]Joseph Dodge and Jay Soled, ''Debunking the Basis Myth Under the Income Tax,'' 81 *Indiana Law Journal* 539 (2006). Dodge and Soled argue that penalty incentives are not strong enough to make it rational for taxpayers to comply with basis rules and that antigovernment anger would suppress compliance even if effective enforcement made it rational to comply.

expected tax on the gain realized in a section 1031 exchange can be expected to be between 2 percent and 4 percent.[17]

B. Reasons for Change

None of the rationales given for section 1031 seem persuasive in view of overbearing revenue needs. It is said that the amount of revenue at stake might not be worth the effort of valuing property received, but the valuation difficulties in modern triangular exchanges are trivial. Stock was taken out of the scope of section 1031 for reasons that seem to apply to real estate as well. Tax on real estate needs to be higher than tax on stock because tax at the shareholder level is a double tax.

1. Administrative: Valuation is not difficult. The primary surviving rationale for nonrecognition of gain on a like-kind exchange is that gain ''would be difficult to determine.''[18] Valuation has been said to require ''continuous litigation.''[19] The net revenue that would be collected from taxing barter exchanges was said to not ''justify the additional administrative expense.''[20] ''If all exchanges were made taxable,'' the House Ways and Means Committee reported, ''it would be necessary to evaluate the property received in exchange in thousands of horse trades and similar barter transactions each year.''[21]

Valuation is not a serious problem in modern like-kind real estate exchanges. In a triangular exchange, the purchaser and taxpayer bargain over the price and the purchaser deposits the agreed-on price with the hired third-party broker. The broker can be asked to give an information return to Treasury concerning what cash was paid by the purchaser for the property. The third-party broker also buys the replacement property at the taxpayer's direction to fit the taxpayer's needs so that there is no ambiguity about the cash price and taxpayer-specific value of the replacement property. Moreover, if there is any boot in the transaction, the parties will have settled the relative value of the property given up and the replacement property down to the penny, so that if there were any doubt about the value on one side of the bargain, that value could be set unambiguously by the extra cash that changes hands. In the leading case on deferred exchange, the taxpayer was given voucher-like ''exchange value credits'' which were equivalent to cash between the taxpayer and the broker.[22] The efforts required to value property when the purchaser deposits cash or the purchaser or third-party broker buys replacement property for the transaction are modest, even trivial. Given the modesty of the efforts required for valuation, a tax on large commercial like-kind exchanges would almost certainly yield revenue for the government.

Barters are taxable, in general, even when there is no related deposit of purchaser cash with a broker and no related purchase of the replacement property. Barters are exchanges without the use of money. In general, taxable income includes not just cash or cash equivalents received by the taxpayer but also income in the form of property or services. For example, when a landlord gives free rent in return for a painting, the painter recognizes compensation income and the landlord recognizes taxable rent.[23] The rule makes sense because dollars have value only to purchase properties and services. Since 1982, the participants in a barter exchange have had to file an information return with the IRS reporting the income on both sides.[24]

It might be possible to try to identify small informal exchanges that are not worth the effort of enforcing taxability. If cash is not paid and debt is not incurred for replacement property in connection with the sale; if the purchaser does not pay the cash purchase price to a third-party broker; if the transaction would not bring $100 in tax; and if the transaction is in a personal context in which the parties will not insist on equality in the bargain, then a de minimis exemption could be tolerated. Natural barters, however, are very rare because the purchaser of the property rarely has exactly the property the taxpayer wants. Cash is so convenient that bargains almost always use cash or a cash equivalent and are hiding the cash in the staged exchange. It would, in fact, be very hard to police the line between nontaxable and taxable exchanges if nonbrokered exchanges were still nontaxable, because the purchaser's cash would just be hidden a bit better. If we are going to spend compliance resources on determining whether the transaction was really a cash deal, we might just as well spend the resources of litigation on the valuation and collect the tax. Given the norm that barters are taxable, no attempt is made in this proposal to carve out informal exchanges too small to tax. Undoubtedly, however, the IRS in its discretion about how to allocate enforcement resources will tolerate some small informal exchanges, or simply might not find them.

Indeed, one would expect that like-kind exchanges would be replaced by explicit cash transactions if section 1031 were repealed. True barters are awkward, high-cost transactions, and subsidizing them with a tax exemption or lower tax rate makes no sense. Indeed, it is plausible that the only reason the purchasers do not pay cash to the taxpayer is that section 1031 allows the taxpayer to avoid tax with a complicated triangular transaction. The professional costs are a waste within the system as a whole.

[17]This calculation assumes a capital gains rate of 15 percent, a discount rate of 5 percent, and 10 years of deferral. The expected tax is calculated as probability of tax times discounted present value: 20 percent*{15 percent/1.05^{10}} = 1.8 percent, and 46 percent*{15 percent/1.05^{10}} = 4.2 percent.

[18]Ways and Means Committee, H. Rep. 350, 67th Cong., 1st Sess. 7 (1921), reprinted in 1939-1 (Part 2) C.B. 168.

[19]Rep. Willis Hawley, 64 Cong. Rec. 2856 (1921), reprinted, J.S. Seidman, *Seidman's Legislative History of the Federal Income Tax Laws, 1938-1861*, at 801 (1938).

[20]Ways and Means Committee, H. Rep. No. 704, 73d Cong., 2d Sess. (1934), reprinted in 1939-1 (Part 2) C.B. 554.

[21]*Id.*

[22]*Starker v. United States*, 602 F.2d 155 (9th Cir. 1979).

[23]Rev. Rul. 79-24, 1979-1 C.B. 60.

[24]P.L. 97-248 (Tax Equity and Fiscal Responsibility Act of 1982), section 311(c)(1), adding section 6045(c)(3).

Repeal section 1031 and staged barter transactions will go away, and all of the professionals involved in setting up the transactions could find employment that makes a better contribution to the economy.

It might also be possible to keep trade-ins of used for new vehicles and machinery from being affected by repeal of section 1031. In a trade-in, the dealer on the other side of the transaction does have property — the new machine — which the taxpayer wants. A dealer trade-in, however, is not an informal transaction. That section 1031 already excepts inventory from nonrecognition is a reflection of the intent to tax commercial exchanges. Dealers have access to broad markets and keep commercial books and records that make valuation reasonable. Gain would arise from a trade-in of machinery only because the depreciation deductions have exceeded the real decline in property. It makes sense to increase the depreciation-adjusted basis accounts to true value once in a generation of machines. The recapture rules of section 1245, for instance, reflect the judgment that ordinary income should be paid when a sale or exchange shows that depreciation has been larger than real losses. Current law already excludes consumer trade-ins from nonrecognition because personal property is not eligible for like-kind exchanges. Thus no exception for trade-ins is proposed here.

2. Stock: The exception that absorbs the rule. In 1923 Congress made stocks, bonds, interests in partnerships and trusts, and legal actions ineligible for like-kind nonrecognition, whether given or received in the exchange.[25] Andrew Mellon, the secretary of the Treasury, argued that tax-free exchanges were being abused because

> many brokers, investment houses, and bond houses have established exchange departments and are advertising that they will exchange securities for their customers in such a manner as to result in no taxable gain. Under this section, therefore, taxpayers owning securities which have appreciated in value are exchanging them for other securities and at the same time receiving a cash consideration without the realization of taxable income, but if the securities have fallen in value since acquisition will sell them and in computing net income deduct the amount of the loss on the sale. This result is manifestly unfair and destructive of the revenues.[26]

There is no distinction between the situation that led Congress to take stocks and other securities out of the nonrecognition provisions and the current situation regarding real estate. Like-kind intermediaries advertise the tax advantage available even when the purchaser pays cash. Taxpayers with gains go into nonrecognition transactions, holding the property until death so that no gain is ever taxed. Taxpayers with losses sell for cash. ''The result is manifestly unfair and destructive of the revenue,'' as Mellon put it. The reason for the exceptions in section 1031(a)(2) absorb the whole nonrecognition rule.

Like-kind exchanges are one of the important advantages that real estate investment has over stocks and bonds and other competing investments, and the advantage is unwarranted. The tax on moving investments in stocks and bonds or personal property from one investment to another is now 15 percent of the gain. There is no immediate tax on moving from one real estate investment to another and, as noted, the expected value of the tax on unrecognized gain, under reasonable assumptions, is between 2 percent and 4 percent.

There is no economic justification for a lower tax on real estate trades than on stocks. Gain on stock sales should be favored for tax purposes, not disadvantaged relative to real estate, because there is already a 34 percent to 35 percent tax on corporate income by the section 11 corporate tax. The corporate-level tax justifies a lower shareholder tax.

Real estate tax advantages, moreover, increase the price of real estate. Insofar as the price is passed through to the price of land, the advantage cannot do good in greater quantity because land cannot expand in quantity. The tax on real estate is low, in general, in comparison to tax on competing investments such as bonds and stocks. The allocation of capital in the country would be improved if tax on real estate were increased vis-à-vis competing investments.

It is sometimes argued that section 1031 is justified because even after the transaction, the ''taxpayer's money is still tied up in the same kind of property as that in which it was invested.''[27] Congress is said to have been concerned with the inequity of taxing ''a paper gain which was still tied up in a continuing investment of the same sort.''[28] Exchanges are accorded nonrecognition, it is said, on ''the underlying assumption . . . that the new property is substantially a continuation of the old investment still unliquidated.''[29] Nonrecognition of gain for like-kind exchanges was also first adopted in 1921 under the shadow of a recent Supreme Court case, *Eisner v. Macomber*, which had held that economic gains were not income, reachable under the 16th Amendment authorizing an unapportioned tax on income, unless the gains were severed from capital.[30]

It is now clear beyond a reasonable doubt that taxation of the gain realized in a like-kind exchange would be constitutional. Reinvestment in like-kind property is not the basis of a constitutional objection to tax. In the year following *Eisner*, the Supreme Court in *Merchants' Loan & Trust Co. v. Smietanka* allowed tax to be imposed on a

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[25]Act of March 4, 1923, P.L. No. 545, 67th Cong., 4th Sess., section 1.

[26]Ways and Means Committee, H. Rept. No. 1432, 67th Cong., 4th Sess. 1, reprinted 1939-1 C.B. 846.

[27]Ways and Means Committee, H. Rep. No. 704, 73d Cong., 2d Sess. (1934), reprinted in 1939-1 (Part 2) C.B. 554, 564.

[28]*Jordan Marsh v. Commissioner*, 269 F.2d 453, 456 (2d Cir. 1959).

[29]Reg. section 1.1002-1(c) (1960).

[30]*Eisner v. Macomber*, 252 U.S. 189, 207 (1920) (finding that the essential requirement in the constitutional definition of income is that the income be severed from capital).

trust's sale of corpus property.[31] The gains from the sale in the case had to be reinvested in corpus and were not distributable or accessible by the income beneficiaries. In *Marr v. United States*,[32] decided four years after *Eisner,* the taxpayer exchanged stock for stock, keeping the gain realized invested in like-kind stock. The Court now would allow taxation of any increase in wealth, even if there is no severance.[33] Realization is now said to be a mere rule of administrative convenience, not of constitutional dimension.[34] Exchange of one pool of mortgages for a replacement pool with nearly identical mortgages is considered a recognition event.[35] The constitutional objections, indeed, were probably always overstated. An exchange, the Supreme Court has said, "has always been recognized as realized taxable gain."[36] No one, in any event, now believes there is any valid constitutional objection to taxing like-kind exchanges.

3. Lock-in. Lower rates on capital gain are said to be required to allow capital to flow from one investment to the next without impediment.[37] Lock-in is a problem for the economy as a whole, however, only if better investments are unable to attract sufficient capital. There is plausibly enough new capital coming into the market from sources that would not require a tax at the gateway to provide the capital for the best investments. Thus capital from individual or corporate earnings, from pension funds that do not pay tax on the rollover of their investments, and especially from foreign sources are a large fraction of the overall supply of capital. Capital that might come from existing real estate with built-in gain is not a large fraction of the whole. The capital without the toll charge at the gate is also adequate to bid to adjust the price of the new investment to be in line with its fundamental value, and so properly signal to the market the allocation of capital according to the underlying merits of the investment. The holder of real estate with significant gain would not be as well off with a tax on section 1031 exchanges, but given that the tax on the gain is mostly a matter of now or never, the equity claims for nonrecognition on the gain are not compelling.

4. Need for revenue. Under reasonable assumptions, there is a need for at least $4 trillion in added revenue over the coming decade.[38] The budget deficits do harm to the economy. The alternative to raising revenue by strengthening the tax base is rate increases, which will also hinder economic growth. Section 1031 is an old loophole, which might have been tolerable when revenue needs were less desperate, but it is a fine source of revenue in the current emergency situation.

C. Explanation of the Proposal

The proposal would repeal the nonrecognition of gain now allowed by section 1031(a). The taxpayer would have a basis for replacement property equal to the fair market value of the replacement property when received and the amount treated as a taxable amount realized.

If the cash or debt in connection with the exchange exceeds $1,000, an exchange broker transferring property to the taxpayer would be required to file an information return with the IRS showing what cash the purchaser paid for the property given up, what the replacement property was purchased for, and what boot changed hands. If there is no broker, but the purchaser buys the replacement property, the purchaser would file the exchange broker information return. If the parties claim that no cash was used to purchase replacement property or was not deposited with a broker, both parties would be required to file the information return.

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[31] *Merchants' Loan & Trust Co. v. Smietanka*, 255 U.S. 509 (Mar. 28, 1921).

[32] 268 U.S. 536 (1925).

[33] *Commissioner v. Glenshaw Glass*, 348 U.S. 426 (1955) (allowing taxation of accessions to wealth); *Helvering v. Bruun*, 309 U.S. 461 (1940) (allowing taxation of landlord's windfall when tenant real estate improvements reverted to the landlord at the end of the lease without a severance from the land).

[34] *Helvering v. Horst*, 311 U.S. 112 (1940) (taxing son when interest coupons were given to son, and saying that the realization requirement is "founded on administrative convenience"), *quoted in Cottage Savings Ass'n v. Commissioner*, 499 U.S. 554, 559 (1991).

[35] *Cottage Savings Ass'n v. Commissioner*, 499 U.S. 554, 559 (1991).

[36] *Helvering v. Bruun*, 309 U.S. at 465.

[37] *See, e.g.,* Schmalbeck, "The Uneasy Case for a Lower Capital Gains Tax: Why Not the Second Best," *Tax Notes*, July 9, 1990, p. 195; Walter Blum, "Rollover, an Alternative Treatment of Capital Gains," 41 *Tax L. Rev*. 385, 387-388 (1986); Ernest Brown, "The Lock-In Problem," in *Papers on Federal Tax Policy for Economic Growth and Stability*; Subcommittee on Tax Policy, Joint Comm. on the Economic Report, 83d Cong., 1st Sess. at 381 (1955).

[38] *See* Alan J. Auerbach, Jason Furman, and William G. Gale, "Still Crazy After All These Years: Understanding the Budget Outlook," *Tax Notes*, May 21, 2007, p. 765.