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Legislative History of Tax Policies Supporting IRC Section 1031

Current Tax Reform proposals emanating from Congress and the Administration make reference to the notion that the "sole" reason for the enactment of IRC Section 1031, administrative convenience, no longer exists, and therefore the repeal of 1031 is warranted. This revisionist history is untrue.

When Congress enacted the like-kind exchange statute in 1921, the legislative history makes clear that **there were three main purposes**. The **two primary purposes**: 1) to **avoid unfair taxation of ongoing investments** in property and 2) to **encourage active reinvestment**, are even more relevant today in our global economy than they were in 1921. The third purpose, administrative convenience, ceased to be relevant in any discussion of the policy underlying the statute as early as 1924.

1. Avoid Unfair Taxation of Theoretical Gains and Losses

The primary purpose of the statute providing for like-kind exchanges of property has always been to permit taxpayers to maintain investments in property without being taxed on theoretical (i.e "paper") gains and losses during the course of a continuous investment. Congress explained:

> 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 a 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.[1]

The statute accomplishes this purpose by exempting from taxation those transactions that represent a continuation of the taxpayer's original investment merely in different, but like-kind, property.

This consideration was "at the root of the Congressional purpose" in enacting this statute.[2] "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."[3]

This analysis demonstrates the basic fairness that is the core of §1031, as well as the intent to stimulate transactional activity, discussed below. For example, the taxpayer makes an initial investment in real estate. Subsequently, the taxpayer may move that investment, changing its form but not its essence. A duplex investment property becomes a six flat, which becomes a strip mall, then a shopping center. As long as the taxpayer stays invested in real estate and does not cash out, any gain is deferred. When the asset is liquidated and the investment ends, the proper tax is paid, as it should be.

This purpose remains valid. By allowing taxpayers to defer the taxes on exchanges of property, the statute avoids the inequity of speculative taxation in the middle of an ongoing investment. Imposing a tax on a continuing investment could not be more contradictory to economic stimulus and growth.

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1 H.R. Rep. No. 73-704, at 13 (1934), *reprinted in* 1939-1 (part 2) CB 554, 564.
2 *Jordan Marsh Co. v. Comm.*, 269 F.2d 453, 456 (2d Cir. 1959).
3 *Id.*

2. Encourage Continuity of Domestic Investment and Transactional Activity

The second stated purpose of the statute is to encourage the exchange of property, thus promoting transactional activity as dictated by prudent business decisions based upon changing circumstances.

> The 1921 Act relieves such transactions from delay, simplifies the tax return, and promotes such exchange of property.[4] [The statute] would permit business to go forward with the readjustments required by existing conditions.[5]

Section 1031 thus provides a solution to the "lock-in" problem of the taxpayer who is unable or unwilling to sell investment property because of the burden that capital gains and recapture taxes would place on the taxpayer's cash flow and net worth. This purpose also speaks to the economic stimulus created by the §1031 incentive to reinvest and expand holdings in the United States, since exchanges of domestic property for assets located or used predominantly in foreign countries do not qualify for tax deferral.[6]

This secondary policy behind the exchange statute continues to be relevant today, freeing taxpayers to invest more actively, encouraging transactional activity, and providing an incentive to direct such activity toward domestic investments. This latter benefit has even greater importance in the global economy that exists almost 100 years after §1031 was enacted.

3. Administrative Convenience

The third original purpose of the statute, administrative convenience, was short-lived and not dispositive. The 1921 Act provided that no gain or loss would be recognized on exchange of property if the property received did not have a readily realizable market value. This was designed to avoid the cost and complication of assigning value, and therefore gain or loss, to property that did not have readily realizable or ascertainable value such as property in a two-party swap. The original statute read, in relevant part:

> For purposes of this title, on an exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value; but even if the property received in exchange has a readily realizable market value, no gain or loss shall be recognized (I) [w]hen any such property held for investment, or for productive use in a trade or business (not including stock-in-trade or other property held primarily for sale), is exchanged for property of a like kind or use.[7]

However, Congress abandoned administrative convenience as a justification for like-kind property exchanges just three years later in 1924[8], when it removed the language referring to a "readily realizable fair market value," recognizing the inherent vagueness of that test.

> The provision is so indefinite that it cannot be applied with accuracy or with consistency. It appears best to provide generally that gain or loss is recognized from all exchanges, and then except specifically and in definite terms those cases of exchanges in which it is not desired to tax the gain or allow the loss. This results in definiteness and accuracy and enables a taxpayer to determine prior to the consummation of a given transaction the tax liability that will result.[9]

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4 61 Cong. Rec. 5201 (1921)
5 H.R. Rep. No. 67-350, at 10 (1921), *reprinted in* 1939-1 (part 2) CB 168, 175-76; *see also* S. Rep. No. 67-275, at 11 (1921)
6 IRC Section 1031(h)
7 Revenue Act of 1921, ch. 136, § 202(c), 42 Stat. 227, 230
8 Act of March 4, 1924, ch. 294, 1, 42 Stat. 1560
9 Committee Reports on Rev. Act of 1924, H.R. Rep. No. 68-179, at 13 (1924), *reprinted in* 1939-1 (Part 2) CB 241, 251

This amendment simplified the statute, confirmed the intent that gain or loss should not be recognized in certain exchange transactions, and further confirmed the intent that paper gains and losses should not be recognized when there is continuity of investment.

There are other indications that Congress never intended administrative convenience to be an essential purpose of the statute. As the Second Circuit Court has remarked:

> [I]f these sections had been intended to obviate the necessity of making difficult valuations, one would have expected them to provide for nonrecognition of gains and losses in all exchanges, whether the property received in exchanges were 'of a like kind' or not of a like kind. And if such had been the legislative objective, §112(c), providing for the recognition of gain from exchanges not wholly in kind, would never have been enacted.[10]

While most properties today that are the subject of exchanges do have a readily realizable and ascertainable market value, this is irrelevant to the modern viability of the exchange statute. Administrative convenience as a policy for Section 1031 has been irrelevant for ninety years, as evidenced by the 1924 change to the language of the statute.

Evolution

The concept of a tax-deferred exchange was new in 1921, and like many new ideas, the concept has evolved in ways that may not have been contemplated at its inception. Treasury Regulations[11] enacted over the years established clear rules to guide modern complicated transactions involving multiple parties, multiple assets, and non-simultaneous exchanges in which replacement property for the exchange is acquired from a third party seller, not from the relinquished property buyer. Part of this evolution included the 1991 creation of the safe harbor role of the Qualified Intermediary in so-called "three corner" deferred exchanges.[12] As part of their service, Qualified Intermediaries, many of whom are attorneys, CPAs or Certified Exchange Specialists®, simplify exchange transactions by using their expertise to guide taxpayers through the process. A positive unintended consequence of these Regulations is that the Qualified Intermediary has become an unofficial gatekeeper for the IRS, promoting technical compliance so that their clients' exchanges will qualify for non-recognition treatment.

Conclusion

Section 1031 and its tax policy underpinnings are still very relevant today, having withstood the test of time from 1921 to the present. While one original purpose of the like-kind exchange statute, administrative convenience, is no longer relevant, and was legislatively abandoned just three years into the new statute in 1924, that purpose was not a primary purpose of the statute. **Both of the *primary* purposes behind the statute, 1) the need to avoid unfair taxation of ongoing investments and 2) the need to encourage active reinvestment, remain just as relevant today as they were almost 100 years ago.** Section 1031 in its present application continues to serve these two policy purposes, benefiting a broad spectrum of taxpayers and stimulating the U.S. economy.

10 Jordan Marsh Co. v. Comm'r, 269 F.2d 453, 456 (2d Cir. 1959)
11 26 CFR 1.1031 et seq
12 26 CFR 1.1031(b)-2, 1.1031(k)-1(g)(4)