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Sidestepping the impact of Starker *to save the two-party tax-free exchange*

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A recent decision by the Oregon District Court, which denied the benefits of Section 1031 because the exchange was not simultaneous, undermined the only direct judicial authority sanctioning deferred two-party exchanges. The authors analyze the meaning of that decision and the planning to avoid its impact.

A RECENT DISTRICT COURT decision, *Starker,* 432 F. Supp. 864 (DC Ore., 1977) (*"Starker II"*), casts doubts on the ability of deferred two-party exchanges to qualify for non-recognition treatment under Section 1031. The term "deferred two-party exchange" means any transaction in which a person who owns real property conveys it to another person with the latter person later acquiring and conveying a parcel of real property to the former person. It is therefore essential that practitioners understand the current implications of this decision, which is on appeal, at least until the Ninth Circuit has rendered a more definitive resolution of the case.

Starker I *and* II *decisions*

Deferred two-party exchanges initially received judicial approval in *Starker,* DC Ore., 4/23/75. The taxpayers (the "Starkers") entered into a real estate exchange agreement in 1967 with Longview Fibre Company ("Longview") pursuant to which the Starkers agreed to transfer timberland to Longview and Longview agreed to transfer to the Starkers similar properties which it did not then own. At the time of the conveyance to Longview, it credited the Starkers with $105,811, which amount increased by 6% each year to reflect the increase in value of the Starkers' land resulting from the growing of timber. The Starkers did not have control over the cash used by Longview to purchase the exchange properties, but they could select the specific properties which they desired to be exchanged. The Starkers did not have the right to demand cash in lieu of the property. However, if there were a credit balance in favor of the Starkers on or after April 1, 1972, Longview had the right to pay such balance in cash (the "Exchange Value Balance"). From 1968 to 1972, Longview transferred eight separate properties (the value of which had been agreed upon by the parties) to the Starkers and by January, 1972, the Exchange Value Balance was exhausted.

On the same day that the Starkers entered into the agreement with Longview, the Starkers also entered into a similar agreement with Crown Zellerbach Corporation ("Crown"). Pursuant to this agreement, the Starkers conveyed timber land to Crown on May 31, 1977. The Exchange Value Balance was exhausted by Crown's 1967 transfer of three separate properties to the Starkers.

On their 1967 Federal income tax return, the Starkers reported the Longview and the Crown transactions as like-kind exchanges under Section 1031. The Internal Revenue Service disagreed.

In the district court, Judge Solomon held that Longview's and Crown's transfers qualified for non-recognition treatment under Section 1031, even though, at the time the agreements were executed, neither Longview nor Crown owned the properties which were ultimately exchanged. While the court acknowledged that there were no decisions directly on point, it believed that the holding in *Alderson,* 317 F.2d 790 (CA-9, 1963), *rev'g.* 38 TC 215 (1962), dictated this result.

Starker II involved the Crown agreement, but in relation to a different taxpayer, T. J. Starker ("T.J."). In addition, *Starker II* was factually diifferent from *Starker I* in that (1) two of the 12 properties transferred by Crown were transferred to T. J.'s daughter and (2) in relation to another of the 12 properties, Crown paid T. J. the purchase price in cash and gave him an assignment of its right to such parcel so that T. J. could buy it himself. Despite these differences, the cases addressed the same issue: whether the transfers constituted "exchanges" which were entitled to non-recognition treatment under Section 1031.

Judge Solomon, who had also presided in the *Starker I* case, held that Section 1031 did not apply since T. J. exchanged his property for a promise which was the equivalent of cash, rather than for like-kind property. He concluded that *Starker I* had been decided incorrectly principally because the rationale of that decision could have the effect of sanctioning a tax-avoidance scheme. In addition, he placed emphasis on the fact that unlike *Starker I,* Crown had transferred property to a third person.

Statutory analysis

As a general rule, Section 1001 provides that gain from the sale or other disposition of property consists of the excess of the amount realized from such sale or disposition over the adjusted basis of such property. The amount realized consists of the sum of any money and the fair market value of property other than money that is received. Unless otherwise provided by the Code, both Sections 1001 and 1002 require that the entire gain realized on the sale or exchange of property is to be recognized. In the case of qualified exchanges, Section 1031 is an exception to these general rules and results in non-recognition if and to the extent its requirements are satisfied.

To qualify for non-recognition treatment under Section 1031 "property held for productive use in trade or business or for investment" must be exchanged solely for "like kind" property.[1] The legislative history of Section 1031 suggests that two factors are given primary significance in determining whether a specific transaction qualifies as an exchange under the predecessor to Section 1031: (1) whether there is qualified property and (2) whether there is a qualified transaction.[2]

The qualified property factor relates to Section 1031's like-kind property requirement. Section 1031 is directed at postponing taxation until there has been a substantial change in the form of investment.[3]

What constitutes an "exchange" has proven to be elusive. Section 1031 appears to be directed only to those transactions whereby one parcel of otherwise qualified property is simultaneously exchanged for another.[4] In reality, however, most exchanges have to be engineered among three parties, the first owns real property he desires to exchange, the second wants to obtain such property from the first, and the third owns real property which the first is willing to receive in exchange for his property and the second acquires such property to accommodate the first.[5]

In light of the qualified property and qualified transaction factors, Judge Solomon's decision in *Starker II* seems sound. Thus, his position appears to be that T. J. received a promise rather than like-kind property (*i.e.*, the transaction was not *reciprocal*) and when T. J. finally received like-kind property from Crown, such transaction was not *simultaneous* with the one in which T. J. transferred his property. *Starker II*, however, provides little analysis as to why the transaction with Crown was not reciprocal and simultaneous.[6]

The timing concept

In any event, several cases decided prior to *Starker I* and *Starker II* have given some definition to the concept of "simultaneity" and, as a result, provide some guidance for the practitioner. In *J. H. Baird Publishing Co.*, 39 TC 608 (1962), *acq.*, the court applied the requirement of simultaneity at the time that beneficial ownership to the affected real property was conveyed, under circumstances where legal title had previously been conveyed. The taxpayer in *Baird* conducted its business in a building, the adjusted basis of which was practically zero. To avoid capital gains tax on any sale, the taxpayer declined offers to buy its building made by a Sunday School association and real estate broker representing such association. The broker later offered to construct a suitable building to exchange with the taxpayer for its building and the taxpayer agreed to such transaction.

On June 12, 1956, the broker obtained an option on land to construct the proposed building. On June 18, 1956, the taxpayer and the broker executed an agreement which provided that (1) the broker could enter into an option on behalf of a third party to purchase the taxpayer's property, but the taxpayer could occupy its property rent-free until the broker provided the taxpayer with a new building; (2) the broker would build a new building whose plans and specifications would be approved by the taxpayer; and (3) the broker would provide cash to the taxpayer to the extent of the difference between $57,700 and the cost of the building. On October 15, 1956, the broker acquired the building lot. On October 31, 1956, the taxpayer executed a deed of its old property to the broker and on the same day such property was redeeded to the Sunday School association for $60,000. The broker established a bank account, as agent for the taxpayer and deposited therein $50,096.89 of the $60,000, the difference being attributable to the cost of the building lot, the broker's commission from the Sunday School association, prorations and fees. Throughout the construction period, the broker disbursed funds as necessary to pay the contractor.

On July 19, 1957, the new building and lot were deeded to the taxpayer and the taxpayer was also given $17,056, which latter amount was treated as boot received in connection with a Section 1031 exchange on the taxpayer's 1957 tax return.

The court concluded that the taxpayer's characterization of the transfer as tax-free was correct, looking to the facts and substance of the transaction. The court first held that the relationship between the taxpayer and broker was not one of principal and agent; rather, the broker acted as its own principal. The court then concluded that the exchange was not effected on October 31, 1956, when the taxpayer deeded its property. Instead it was effected on July 19, 1957, when the new building was deeded to the taxpayer; delivery of the first deed was merely one step in an integrated exchange in which only legal ownership, but not beneficial ownership, was surrendered. On July 19, 1957, when the taxpayer gave up beneficial ownership (as evidenced by its rent-free use of the land) in favor of the Sunday School association and received ownership of the new property, the exchange was effectuated (and the $17,056 boot became taxable). At that time, beneficial ownership of the old property passed from the taxpayer to the broker to the Sunday School association. Accordingly, the court was satisfied that the transaction was a "reciprocal and mutually dependent" transfer satisfying Section 1031's requirements.

In *Borchard*, TCM 1965-297, the court held that Section 1031 applied to the transaction under consideration even though the taxpayer agreed to receive cash if acceptable exchange property could not be found. At issue in *Borchard* was appreciated farm land located in Orange County, California, owned by the taxpayer, which Burroughs Corporation desired to acquire. The parties entered into an agreement whereby the taxpayer agreed to convey the Orange County property to Burroughs for (1) cash, (2) exchange property, or (3) a combination thereof. Burroughs agreed to deposit $25,000 cash in an escrow to be credited against the purchase price of the exchange property or, alternatively, the purchase price of the Orange County property. Some time after execution of the agreement, the taxpayer located acceptable exchange properties in Imperial County, California, which the taxpayer deemed roughly equivalent in value to the Orange County property. Burroughs entered into escrow arrangements with the four owners of the ap-

[1] This article does not deal with receipt of "boot" in addition to like-kind property (Sec. 1031(b)).

[2] In 1924, Congress enacted Section 203(b)(1), Revenue Act of 1924, predecessor to Section 1031, to resolve some of the uncertainty which surrounded the tax treatment of exchanges of like-kind property under prior legislation.

[3] See H. Rep't. No. 704, 73rd Cong. 2d Sess. 13 (1939). See also *Jordan Marsh Company*, 269 F.2d 453 (CA-2, 1959), *rev'g.* TCM 1957-237 1957 and *Century Electric Co.*, 192 F.2d 155 (CA-8, 1951), *aff'g.* 15 TC 581 (1950) *cert. den.*, citing *Fairfield S. S. Corp.*, 157 F.2d 321 (CA-2, 1946).

[4] In certain unique cases, the IRS and courts have even disregarded the form of the transaction. See *Rev. Rul.* 57-469, 1957-2 CB 521; *Century Electric Co.*, *supra* and *Horne*, 5 TC 250 (1945).

[5] See *Rev. Rul.* 75-291, 1975-2 CB 332 and *Rev. Rul.* 77-297, IRB 1977-34, 12.

[6] In footnote 3 to *Starker II*, 432 F. Supp. 864 (DC Ore., 1977), Judge Solomon complicated his analysis by indicating that he was not then deciding that all Section 1031 transactions require simultaneous transactions.

[7] See *Rev. Rul.* 69-93, 1969-1 CB 139, which provides that real property is sold "at the time the deed [passes] or at the time possession and the burdens and benefits of ownership [are], from a *practical standpoint*, transferred to the buyer." (Emphasis added.) No authority explains the term "practical standpoint," although it would seem logical that if the developer undertook grading and excavating, without any right to reimbursement from A, ownership of A's property would not be considered to be transferred. *Cf. Siemers*, TCM 1977-221 and *Merrill*, 40 TC 66 (1963) *aff'd. per cur.* 336 F.2d 771 (CA-9, 1964).

[8] *Powell*, TCM 1967-32.

proved exchanged parcels. The court held that this exchange qualified under Section 1031 despite the fact that the agreement provided that the taxpayer had to sell the Orange County property for cash if acceptable exchange property were not located.

Alderson, relied upon by Judge Solomon in deciding *Starker I,* is probably the most important case analyzing the issue of simultaneity under Section 1031. In *Alderson,* the taxpayer agreed to sell his agricultural property ("Buena Park") for $172,871 in cash to Alloy Die Casting Company ("Alloy"), even though he had always intended to exchange it. One-tenth of the purchase price was deposited with an escrow company ("Orange"). Sometime after the execution of the original agreement, the taxpayer located farming land (the "Salinas Property") which he desired to exchange for Buena Park. Consequently, Alloy and the taxpayer amended the original agreement to change the transaction from a cash deal to an exchange of properties. The amendment also provided that if the exchange was not effected by a specified date, the cash transaction would be consummated.

On the same day as the execution of the amendment to the escrow instructions, the taxpayer's daughter executed escrow instructions with another escrow company ("Salinas Title"), which provided for payment of $190,000 for the Salinas Property. The escrow instruction also provided for the deposit of 10% of the $190,000 purchase price for the Salinas Property and authorized Salinas Title to deliver the deed for the Salinas Property to Alloy on the condition that Salinas Title immediately record a deed from Alloy to the taxpayer conveying the Salinas Property. The taxpayer then authorized Orange to pay the original deposit (and later the purchase price) into the Salinas Title escrow.

Title to the Salinas Property was first transferred to Salinas Title, then by a deed dated one day later, to Alloy. Almost a week later, the taxpayer conveyed Buena Park to Alloy and Alloy, by a deed dated three days thereafter, conveyed the Salinas Property to the taxpayer.

Although the taxpayer authorized Orange to pay 10% of the purchase price for the Salinas Property into the Salinas Title escrow and then to pay the balance of the purchase price for such property when available into the Salinas Title escrow, and although the Salinas Title escrow provided for the deposit of the balance of the purchase price into the Orange escrow, this was not done. Rather, Alloy's property, worth approximately the balance of the purchase price for the Salinas Property, was deposited in the Salinas Title escrow in Alloy's behalf. A week later, Alloy deposited the balance of the purchase price of the Salinas Property into the Salinas Title escrow indicating that such money should be used to complete the purchase of the Salinas Property. Alloy's original 10% deposit in the Orange escrow was refunded.

The court acknowledged that "the intermediate acts of the parties could have more precisely hewn closer to and have more precisely depicted the ultimate desired result." However, the court held that despite the initial agreement to consummate a cash deal, the transaction was in essence consummated as an exchange and qualified for non-recognition treatment under Section 1031. The court did not discover any intent on the part of the parties to disguise the nature of the transaction.

Planning possibilities

After *Starker II* there is no direct judicial authority sanctioning deferred two-party exchanges. Given the present state of the law, in order for a two-party exchange to qualify under Section 1031, it would seem necessary for each party to receive legal title and the other incidents of ownership of like-kind properties at approximately the same time. Despite this legal climate, several planning possibilities may still be present for clients who request that a tax adviser arrange a deferred two-party exchange.

To illustrate such planning possibilities, assume that a person ("A") owns a parcel of unimproved property which a developer seeks to acquire immediately. Assume further that A is only willing to exchange his property, but has not selected a parcel for the developer to acquire to exchange with him.

One method by which A may be able to meet the requirements of Section 1031 would be to arrange a sufficiently long period between the time that the exchange agreement is entered into and the time the transaction is to be consummated (*i.e.,* the time when A transfers ownership of his property to the developer) so that the developer can acquire a suitable parcel of property to exchange. If a lengthy period between execution of an agreement and consummation results in no business risks to A, such period could enable the developer to commence preliminary work, such as obtaining zoning, complying with subdivision requirements, grading and excavating.[7]

A further possibility would be for A to transfer only a portion of his property (*i.e.,* the parcel that would constitute the first phase of development) to the developer and incur any gain on the sale of such parcel, deferring the transfer of the balance until the developer has acquired a suitable piece of property to exchange. However, in the case of improved parcels of property, such an alternative may not be feasible.

A variation of the foregoing alternative, applicable to both improved and unimproved parcels, would be to convey to the developer or other "buyer" a portion of the property as a fractional tenancy in common in a taxable transaction, deferring conveyance of the balance of the property until such time as the developer or "buyer" has acquired a suitable piece of property for exchange. A tenant-in-common has the right to enter on to the property and commence development or other activities and this right may satisfy the developer's or other "buyer's" desire to acquire the property immediately.[8]

Conclusion

As a result of *Starker II,* practitioners should reevaluate advising clients to undertake deferred two-party exchanges. To the extent *Starker I* provides authority, if any, for undertaking such exchanges, that authority has been negated by Judge Solomon's more recent decision in *Starker II.* Despite *Starker II,* however, a practitioner may still be able to achieve substantially the same tax benefits as those under a deferred two-party exchange with other techniques. ☆

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Mortgage refinancing bars installment reporting

IN *Maddox,* 69 TC No. 72, a taxpayer discovered that an ordinary sort of real estate transaction disqualified him from using the installment method of reporting gain on properties which he had sold.

The taxpayer owned 12 parcels of real estate, each of which was subject to a mortgage. Each parcel was sold under the following conditions: an escrow was created, under which each purchaser was to obtain a new loan on the property. The loan proceeds were used to pay off the taxpayer's existing mortgage, and the excess proceeds were paid to the taxpayer at the close of the escrow. In only one case was the taxpayer's adjusted basis less than the existing mortgage liability at the time of sale.

The taxpayer reported his gain on the sale using the installment method. The Service decided that the taxpayer was ineligible for the installment method and the Tax Court agreed.

The dispute centered on the refinancing arrangements under which the buyers acquired the property. The taxpayer argued that the substitution of new mortgages for the existing ones was tantamount to the assumption by the buyers of the existing mortgages. Under the circumstances, the taxpayer pointed out, he had no right to the mortgage proceeds but could only receive his redemption interest, *i.e.,* the difference between the amount of the existing mortgage and the sales price, and thus was the same as if an assumption had occurred.

However, the Tax Court found the Service's position more persuasive. It held that paying off the existing mortgages constituted payments to the taxpayer in the year of sale. Since the total of such payments exceeded 30% of the selling price, the taxpayer was barred from using the installment method. Despite the use of escrows, the effect of the transactions was as if the seller had received additional cash and had used it to pay off the mortgages himself.

The Tax Court pointed out that at the close of the escrows the seller had no remaining liability whatever under the mortgages, which were cancelled. If the taxpayer had wished to preserve the right to elect installment reporting, the purchaser would have had to take the property subject to or assume the existing mortgage. In that event, Reg. 1.453-4(c) provides that the amount of the mortgage shall not be taken into account as a payment in the year of sale except to the extent that the existing amount of the mortgage exceeded the seller's basis in the property.

Three prior Tax Court cases were relied on by the taxpayer, but the court distinguished the facts in all three from the facts before it. In those cases, *Waldrep,* 52 TC 640 (1969), *aff'd.* 428 F.2d 1216 (CA-5, 1970); *Richards,* TC 1972-126, and *Voight,* 68 TC 99 (1977), the selling taxpayer remained liable to some extent and the purchaser was held to have assumed the mortgage within the meaning of Section 453. Even where the transaction was not an assumption in form, if such was intended or could be implied, the Tax Court was willing to find that, in substance, an assumption had occurred. Such an inference in *Maddox,* was "not feasible."

Selling taxpayers should thus take note that their sale documents preclude a refinancing in the year of sale if they expect the benefits of installment reporting. Suppose that the buyer had assumed the existing mortgage and the lender relieved the seller of liability. Would the same result have occurred? ☆

Conveyance of title may bar use af 453 with wrap-arounds

Two RECENTLY RELEASED technical advice memoranda cast doubt on a seller's ability to elect installment reporting under some circumstances when wrap-around mortgages are involved. In both L.R. 7814010 and L.R. 7814011, the Service concluded that the property sold had been taken subject to the mortgage by the purchaser, and the amount of the mortgage in excess of the seller's basis was included in the payments received in the year of sale.

In both transactions the sellers continued to make payments on the mortgages and the purchasers were obligated to make payments to the sellers. However, title to the properties was transferred by deed to the purchasers in the year of sale. The sellers relied on three Tax Court cases in which similar arrangements were involved: *Stonecrest Corp.,* 24 TC 659 (1955), *nonacq.; Estate of Lamberth,* 31 TC 302 (1958), *nonacq.* and *United Pacific Corp.,* 39 TC 721 (1963). The IRS distinguished these three cases from the situations present in the private letter rulings on the grounds that there was no conveyance of the property sold in any of the three cases until long after the year of sale. In the words used by the Service in the rulings, "in those cases conveyance of the property was neither contemplated by the parties in the year of sale nor did conveyance occur at that time." On the other hand, the transactions in the rulings involved a sale as well as a conveyance by deed to the buyer in the same year. The Service found this to be the crucial determinant, rather than the "similarity of the mechanical aspects of the taxpayer's transaction" *(i.e.,* the provisions as to payments) to the three Tax Court cases.

In *Stonecrest,* the taxpayer won because the court found that there was no present assumption of the mortgage, nor did the purchaser take the property subject to the mortgage. The sale agreement contemplated that "the purchaser was to make payments on the purchase price for a period of time, after which [Stonecrest] was to pass title to the property and the purchaser was to take over the remaining mortgage payments." In *Lamberth,* the court held that in calculating the application of the installment method the Service "should have eliminated from the total selling prices only the amounts of the mortgage debts which would not be paid during the contract periods and before titles were to be conveyed to arrive at the total contract prices." The sales agreement in *United Pacific Corp.* provided for a conveyance and assumption five years after the sale and the court held that this was indistinguishable from *Stonecrest* and *Lamberth.*

At the time that *Stonecrest* was decided, the point the Service was urging was that any time a mortgage was involved, a taxpayer had to include the excess over his basis in the sales price. The Tax Court held to the contrary, requiring that the mortgage be first assumed, or that the property be taken subject to it. However, it appears from the language in all three opinions that part of the Tax Court's decision rested on the sellers' retention of title. This supported the court's finding that the property had not been taken subject to the existing mortgage. Thus, it seems for wrap-around mortgages to be used in successful conjunction with installment reporting under Section 453, a seller ought to retain title to the property beyond the year of sale. ☆