VIEWPOINT

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The Tax Policy Case for Section 1031

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In this article, Susswein, McCormick, and Brown analyze and compare the well-established tax policy case for not recognizing gain in the formation and restructuring of corporations and partnerships (transactions governed by sections 351, 368, 721, and 731) with the case for nonrecognition under the like-kind exchange rules of section 1031.

The views expressed are solely those of the authors, not necessarily those of their organizations, and not intended as tax advice.

Introduction and Overview

The tax law has long treated most business entity formations, restructurings, and combinations as transactions that do not, and generally should not, give rise to the recognition of gain (or loss). This is true even though they all involve a transfer of property, from one taxpayer to another, in exchange for property that is materially different in kind — the classic definition of an event requiring the realization (and taxation) of any built-in gain in the transferred assets. Even so, nonrecognition has traditionally been justified by the assertion that the differences in these cases are "more formal than substantial."

In reality, that explanation doesn't hold water. The business formation and reorganization provisions allow for nonrecognition even when there are significant substantive changes, in some cases fundamental changes, in the nature of the taxpayer's business risks and opportunities before and after the transaction.

There is a much better explanation for the nonrecognition treatment provided for business formations and restructurings, an explanation that applies with even greater force when business or investment property is exchanged for "like-kind" property under section 1031.

Despite the many forests that have given their lives to such shibboleths as "control" or "continuity of business enterprise," the real argument for nonrecognition, in business entity formations and restructurings, comes down to two basic points.

First, the nonrecognition rules ensure that the built-in gain or loss (and other tax attributes) of the party benefiting from nonrecognition are preserved, for future taxation in the ordinary course, much as if the transaction had not occurred. This is true even as future gains or losses attributable to the transferred property inure, economically and taxwise, to a different taxpayer. This ensures that the tax system does not lose any revenue, compared with what would have happened if the transaction had never occurred.

Second, although nothing is guaranteed, there is a possibility that the assets, formally moving from one owner to another, will be more effectively or efficiently managed or operated as a result of the change in formal or economic ownership. Thus, there is a possibility that they may produce more economic income (and more taxes) than would be the case if the transaction had not occurred.

With a guarantee against a loss of tax revenue (compared with maintaining the status quo) and the possibility that the assets will generate more income in the future (compared to maintaining the status quo) the tax system wisely treats nonrecognition as a no-lose proposition. That is, (1) heads the IRS doesn't lose, and (2) tails the transaction results in enhanced economic performance of the underlying assets, with the result that the IRS (along with the taxpayer who owns the asset) wins. This policy is not only prudent, it has become part of the DNA of the U.S tax system. Without it, our economy would be quite different, probably not for the better.

Viewing the business formation and reorganization provisions in this light, like-kind exchanges under section 1031 are certainly no less deserving, and in many cases present an even stronger tax policy case for nonrecognition.

Understanding the Entity Rules

To understand why the tax law has evolved to bend so far in the direction of nonrecognition, it may be helpful to explain what is meant by a "built-in" or "unrealized" gain. First, we are not talking about an improvement or increase in the ordinary operating income of a business or business entity that somehow avoids tax. If a business or investment generates more income this year than last year, that income is generally taxed immediately as ordinary income. There is no way to avoid those taxes using any of the tax provisions we are discussing.

Ostensibly, unrealized gain refers to the market value of an asset in excess of its basis. In the case of most business or income-producing assets, however, this market value is best understood as the combination of two factors: (1) a speculative projection of the asset's ability to generate income in the future; and (2) a perception of the asset's liquidity, or more specifically, the owner's ability to convert the anticipated future stream of income into a lump sum today. Only if the market perceives that a business or income-producing asset is likely to generate an enhanced amount of future operating income on a sustained basis, year after year, will the value of the asset, as a source of future operating income, increase. By its very nature, that is speculative. In the case of a nonpublicly traded or illiquid asset, when there is no readily ascertainable market value, it is often little more than an educated guess about what the asset could sell for, based on a hypothetical buyer's projection of how much future income the asset is likely to generate.

Even so, when a business is restructured, even in a minor way, such as converting a sole proprietorship into a wholly owned corporation, the tax law may conclude that there has been an exchange that constitutes a "realization" of these anticipated future profits — as if the taxpayer had sold his business or income-producing property for cash. While that may be a useful theoretical concept, it is not very helpful if one wants to have a functioning economy. For sound practical reasons, the notion that gain should be taxed whenever it "realized" has been honored in the breach.

Most obviously, if the taxpayer has merely exchanged one illiquid asset for another, he may not have any cash available to pay taxes. More importantly, even if cash flow is not a problem, if a proposed business restructuring cannot be done without triggering a significant tax liability, the taxpayer may simply decide to maintain the status quo, even if it is not ideal as a business matter. For example, instead of forming a two-person joint venture to own or operate business or investment property, one party could simply lease, loan, or license his property to the other, retaining enough incidents of ownership to avoid triggering gain recognition. That might be more cumbersome, and less efficient, than completely combining their assets and efforts and sharing the net profits (or losses). However, because no property is transferred or exchanged no gain is realized.

To use an analogy, if the New York and New Jersey authorities impose new tolls on the bridges and tunnels crossing the Hudson River, some dedicated commuters will undoubtedly pay them, but others will simply work from home in New Jersey. That may entail a loss of efficiency or effectiveness for the workers, as well as a loss of toll revenue. To eliminate or reduce the tax "toll charge" on business formations and restructurings, the tax law developed the concept of nonrecognition. Even though gain (or loss) is technically "realized" when one piece of property is exchanged for a materially different piece of property, the tax law has developed an extensive series of exceptions providing that gain (or loss) isn't to be recognized.

Although these are sometimes described as "tax-free" or "tax-deferred" transactions, it might be more accurate to say that the tax law is only trying to preserve the status quo. That is, the economic transaction is allowed to proceed, but the computation of the income or deductions generated by the transferred or exchanged assets doesn't change, almost as if the transaction had not occurred or had occurred between two branch offices of the same law firm or two divisions of the same corporation.

That is, in the aggregate, the income generated by the exchanged assets is computed, as much as possible, as if the parties were continuing to own and operate their own historical assets. However, that income will be reported by different taxpayers, sometimes in different proportions, consistent with the substantive changes effected by the transaction.

A few examples may illustrate how the nonrecognition rules ensure that there is no diminution of tax revenue, compared with what would have happened if the transaction had not occurred.

Business formation. In the simplest possible case, if the assets of a sole proprietor are contributed to a newly formed S corporation in exchange for all the company's stock, the company's taxable income (as reported on an S corporation tax return) generally won't differ from what would have been reported on the taxpayer's Schedule C as part of his individual Form 1040 return.

If the entity were a C corporation, the income computation also generally wouldn't change, although the tax rates applicable to the C corporation may differ, reflecting the fact that the taxpayer has voluntarily decided to convert from a sole proprietorship to a C corporation with all the associated benefits or detriments.

Business merger. Taking it one step further, if the owner of a chain of doughnut shops and the owner of a chain of bagel shops combined their operations into a 50-50 partnership that will operate stores selling bagels and doughnuts, their aggregate income and deductions should not change (absent a change in economic performance). However, the two partners will each be participating in 50 percent of the combined entity's economic and tax results, not 100 percent of the economic and tax results of their previously separate businesses.

Partnership division. Another case would be presented if two partners, A and B, created a business from scratch in which A would market and sell doughnuts and bagels prepared under B's culinary supervision. After a few years they might conclude that it made more sense to sell only bagels in their retail shops while splitting off their wildly popular doughnut brand and marketing that through supermarkets, an endeavor for which A was particularly well-suited. If it made sense as a business matter, the bagel operation and bagel brand could be distributed (without gain recognition) to B, while the doughnut brand was distributed to A.

If there were four partners, the partnership could be divided into a B-D bagel partnership and an A-C doughnut partnership. In all cases, the tax basis of the distributed assets, mostly goodwill along with some leases and food service equipment, would carry-over as the basis of those assets after the division or liquidation. In the aggregate, unless the business assets did better, or worse, on a pre-tax basis as a result of the division, the taxes paid to the IRS would be identical. If the parties were correct in predicting that they would both earn more money this way, IRS tax receipts would also increase.

What Justifies This Treatment?

In all these cases, to use an old cliché, our long-established tax policy seems to keep its eye on the doughnut and not on the hole. That is, the focus is on the potential future economic value created by the restructuring or change in ownership, including a possible increase in future ordinary income, instead of viewing the transaction as an opportunity to impose a tax based on a projection of the parties' future income. Recognizing that imposing a tax "toll charge" could stop some transactions in their tracks — a "lose-lose" proposition — the underlying tax policy is to ensure that projected tax revenues are not diminished compared with what they would be if the transaction did not occur. With assurance that there will be *no harm* to the revenues, the transaction is allowed to proceed without accelerating gain.

In a business restructuring, valuable assets such as contracts to purchase materials at a discount or to sell goods at a premium, or the goodwill of a successful business, may change hands. If there is no change in economic performance as a result of the change in ownership, whether it is a combination or division or a change in management philosophy, there will be no reduction in tax revenues. If aggregate profits do increase as a result of the ownership change those profits should produce increased tax receipts, as well as the obvious benefits for the owners. However, those increased profits, and increased tax revenues, will occur in the ordinary course as and when new business is generated. In that sense, although these transactions are sometimes referred to as "tax deferred," it may be more accurate to describe them as transactions in which tax is not accelerated.

It may be interesting to note why we have not typically viewed some nonrecognition transactions through this lens. Until the 1990s, most profitable business activity was conducted through C corporations. If a C corporation is only partially taxed on its earnings at the corporate level (with a 21 percent rate or perhaps a 28 percent rate) with the second part of the tax deferred until earnings are distributed, the gain that is not recognized is not only an estimate of the company's speculative future profits, it might include some of the corporation's undistributed (and thus not yet fully taxed) operating income from past periods. Be that as it may, except for those C corporation cases, the built-in gain in a business or business asset is generally a projection of future ordinary income that will be taxed only when it is generated.

That said, perhaps the most surprising thing is how pro-growth our tax policy is toward C corporation formations, restructurings, and combinations — even allowing for the nonrecognition of gain representing ordinary operating income from past periods. As we explain below, that is another important area in which section 1031 compares favorably. If a parcel of appreciated rental property is exchanged by a non-C-corporation taxpayer without recognition of gain for another parcel that is more suitable to the taxpayer's business or profit-making objectives of the transferor, the unrecognized gain only represents the market's projection of the future cash flow the property may generate (or an appraiser's best guess as to what the market would project if the property were sold).

Particularly when C corporations are involved, but whenever nonrecognition applies, one may ask what rationale supports these exemptions from the normal realization rules? The tax law certainly acknowledges that gain (or loss) is realized when property is exchanged for other property that is materially different in kind. However, as explained by long-standing tax regulations first adopted in 1957, the tax law views the differences here as "more formal than substantial."[1] Thus, "the code provides that such [formal] 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

[1] Reg. section 1.1002-1.

the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated."[2]

But is this correct? Are there only formal differences between the properties exchanged and received in these business entity transactions?

In our first example, that seems to be the case — when a sole proprietor contributes his business to a wholly owned corporation or even a family-owned partnership. In other cases, like our doughnut-and-bagel merger, the differences can be substantial. And sometimes the taxpayers seem to be fundamentally changing the nature of their business risks and opportunities for profit.

Nonrecognition and the Tax Law's Permissibility

The full range of cases allowing for nonrecognition under the business entity rules is well illustrated by an example in the long-standing regulations under section 351[3]:

> C owns a patent right worth $25,000 and D owns a manufacturing plant worth $75,000. C and D organize the R Corporation with an authorized capital stock of $100,000. C transfers his patent right to the R Corporation for $25,000 of its stock and D transfers his plant to the new corporation for $75,000 of its stock. No gain or loss to C or D is recognized.

Obviously, C and D have changed the form of their investments — from direct ownership of property to the ownership of corporate stock — which may provide some business efficiencies or legal protections that would be unavailable if they were operating as sole proprietors. Few would consider that change significant enough, as a policy matter, to trigger the recognition of gain (or loss). Indeed, under the law, C or D could obtain similar benefits merely by forming their own single-member LLCs. That wouldn't even be treated as a realization event because the tax law doesn't formally recognize a single-member LLC as a distinct taxpayer.

The surprising thing about this example — which dates from the same era as the regulation quoted above — is that C and D are both permitted to make what seem to be substantive, and perhaps even fundamental, changes to the nature of their business activities. C has exchanged his patent right for a minority interest in a manufacturing company that, the reader might infer, is ready to start manufacturing and selling products using C's patent, perhaps exclusively. The change might be less dramatic for D, but any qualified financial adviser would certainly have advised the parties that D was giving up 25 percent of his existing manufacturing business to acquire 75 percent of C's patent rights, while C was giving up 75 percent of his intellectual property rights to acquire a 25 percent interest in D's manufacturing business. If the tax law were truly making exceptions only for differences that were "more formal than substantial," Congress might have concluded that only 25 percent of C's contribution and only 75 percent of D's contribution should qualify for nonrecognition.

It could be argued that it was only to that extent that the parties were holding "new property [that] is substantially a continuation of the old investment still unliquidated." C was arguably continuing only 25 percent of his prior investment because he was only subject to 25 percent of the risks and rewards associated with his previously owned patent right, and D was continuing only 75 percent of his prior investment because he was only subject to 75 percent of the risks and rewards associated with his previously owned manufacturing business. It isn't that different from C having sold an undivided 75 percent interest in his $25,000 patent right for $18,750 of cash, which he then used to purchase a 25 percent interest in D's $75,000 manufacturing business, or D having sold an undivided 25 percent interest in his $75,000 manufacturing business for $18,750 of cash, which he then used to purchase a 25 percent interest in C's $25,000 patent right. After that portion of the gain was recognized, putting all the assets into a single entity would legitimately be viewed as little more than a "continuation of the old investment[s] still unliquidated" — a difference "more formal than

[2] *Id.*

[3] Reg. section 1.351-1(a)(2), Example 1.

substantial" — that would conform to this rationale for nonrecognition.

As can be seen, even in the simple case of C's patent and D's manufacturing plant, the rationale for nonrecognition provided in the regulation quoted above doesn't provide a very satisfactory explanation. The nature of C's business risks and opportunities for profit have changed almost completely. Also, C may not have any control, or even a voice, in the management of the ongoing business. Although section 351 requires that the contributing parties, as a group, own 80 percent or more of the voting power of the surviving entity (and at least 80 percent of any nonvoting shares), that requirement is little more than a formality if the parties are forming the entity as part of an integrated plan, and no control test applies when property is contributed to a partnership.

From C's perspective, if D is the right company to manufacture and sell C's patented product, or to use C's patented process, all will be well. If not, C has made a potentially fateful change. On the other hand, if D's manufacturing business prospers unexpectedly, for reasons having nothing to do with C's patent, C's economic prospects may be bright, even if his patent turns out to be worthless. Conversely, D has "bet the company" — or at least 25 percent of it — on the value of C's patent rights, which may be a function of legal risks as well as business and economic risks. Also, this isn't an outlier. Similar changes in economic and business risks and potential rewards occur even more commonly in connection with mergers or combinations of two or more existing business entities.

Summarizing the Real Policy?

Perhaps there is a better explanation for nonrecognition in the business entity context, the major elements of which would be the following.

First, the technical rules governing these nonrecognition transactions largely ensure that there will be no material change in the amount, timing, or character of the taxable income or deductions that would have been generated by the transferred property if the transaction had never occurred. That is to say, the transaction itself won't cause a diminution of tax revenues, compared with what would occur if the parties had merely preserved the status quo. Also, to the extent unrealized gain reflects a prediction of an increased amount of future ordinary income, that income will be taxed in the ordinary course, with or without the transaction. Also, if any built-in gain assets are later sold, the gain will be recognized at that time.

Second, there is almost always a significant change in the nature of the transferor's business or investment risks and opportunities for pretax profit or loss. Indeed, if there were no such change, there might not be any nontax business purpose for the transaction in the first place. If two purported partners, for example, merely contributed their property to the same entity and took back the exclusive rights to profit from the separate property each had contributed, the entity might not even be considered a partnership.

That there is, at the very least, a possibility of enhanced economic performance is a good thing for everyone. If the transaction does improve economic performance, that should be a win-win. The income generated by the exchanged assets will be computed as if nothing had changed, but there will be more of it. If it doesn't, that should be a no-win, no-win. The tax status quo is preserved, and, with hindsight, we will know that there was little justification for imposing a tax as a precondition of doing the deal. If the parties had been able to see the future, they would never have made the exchange, and no taxes would have been accelerated. It is hard to see any way in which the tax collector has "lost."

Third, there is no way to know, in advance, whether the parties' business judgments are correct. We have to wait to see whether any specific business entity formation, combination, or restructuring ends up increasing the parties' aggregate future profits. Unless the IRS can effectively predict how successful or unsuccessful any specific business or business combination will be, it cannot pick winners and losers. Thus, no useful purpose would be served by using the tax law to erect tax obstacles or toll charges that must be paid as a condition to going forward with what appears to be a non-tax-motivated transaction. The most optimistic entrepreneurs may be willing to pay a modest tax and proceed with the transaction, while the more pessimistic may simply abandon the transaction if they are required to pay a tax toll charge. Unless there is correlation between optimism and actual business success, imposing a tax charge as a condition to moving forward with what are clearly non-tax-motivated transactions appears to be a lose-lose strategy, even from the point of view of an avaricious (but enlightened) tax collector.

To summarize the unstated but apparent tax policy that runs throughout the tax code: if (1) there is a possibility that the transaction will improve or enhance how the contributed or exchanged property will be used to generate economic value, and (2) the tax basis (and other attributes) of the exchanged properties is adjusted to ensure that the parties' aggregate future tax obligations are unlikely to be diminished as a result of the transaction (compared with what would occur if the transaction didn't occur), then (3) the tax law shouldn't impose any tax obstacles or toll charges (including the required acceleration of gain) that might prevent the transaction from occurring.

There are cases, but relatively few, when there is demonstrably no possibility of enhanced economic performance as a result of a property exchange. For example, imagine that C and D were forming a new partnership into which C was contributing $25,000 of stock in X, a publicly traded company that owned and licensed hundreds of patents, while D was contributing $75,000 of stock in Y, a publicly traded company that paid royalties for the use of 20 or 30 patents at any given time. C or D might benefit from enjoying greater diversification of their stock portfolios — and if that were all that was involved, it would be an argument for recognition.

Because some change or diversification will inevitably occur in almost all business formations or reorganizations, as the example of C's patent and D's factory illustrates, that alone isn't a compelling argument for imposing a toll-charge in the form of gain recognition. When there is no possibility of any benefit other than diversification, nonrecognition is hard to justify. Thus, where C and D are merely exchanging or combining their holdings of publicly traded stock, and there is *no possibility* that the actual patents owned by X would be put to any better or more efficient use after the transaction, gain recognition is appropriate.

This bright-line test — requiring recognition when there is a no possibility that the exchanged assets will be operated more efficiently or effectively after the transaction — seems to explain why, in sections 351 and 721, nonrecognition is not allowed for contributions of publicly traded securities (or similar property) to a mutual fund or similar entity whose assets are mostly other readily marketable securities. In such a case there appears to be no possibility of any enhancement in the performance of the underlying assets — either the stocks or securities or their underlying assets — as a result of their transfer to a different entity. Evidently for similar reasons, a comparable list of portfolio assets is excluded from the types of assets that can be exchanged under section 1031.[4]

Outside of clear-cut cases like this, however, Congress doesn't question the parties' business decision to combine or exchange their resources for the ostensible purpose of improving their aggregate pretax economic performance. Simply put, Congress is willing to take the risk of *not* accelerating tax revenue as long as there is at least *some* possibility that allowing the transaction to proceed will improve the economic performance of the assets. By the same token, Congress avoids the possibility that imposing a tax toll-charge will simply stop the transaction from proceeding in the most efficient way, a lose-lose proposition.

The same philosophy is embodied in the rules that would apply (under section 368 and related provisions) if C and D were existing corporations that were seeking to merge or in the rules that would apply (under sections 721 and 731) if C and D had formed a partnership, merged two or more partnerships, or (subject to specific limitations) split up or liquidated an existing entity that no longer made business sense.

Interestingly, in the partnership context (subject to limitations), bigger isn't necessarily better. That is, it doesn't matter if the restructuring is leading to the creation of larger and more

[4] Section 1031 doesn't allow for the exchange of "stocks, bonds, or notes . . . other securities or evidences of indebtedness or interest . . . interests in a partnership . . . certificates of trust or beneficial interests . . . or . . . choses in action." Although it applies to "investment" property (now only real property) as well as property held for use in a business, the concept of "investment property" doesn't include these portfolio assets.

diversified business entities or smaller and more specialized entities.

For example, imagine that the R partnership had been formed with $100,000 of cash contributed by C and D, and the cash was used to purchase or construct $75,000 of manufacturing facilities and to purchase $25,000 of patent rights from an inventor. After several years of successfully introducing the inventor's product to the market under R's brand, C and D might conclude that they could make more money by licensing the patent rights to other manufacturers while continuing to operate a traditional manufacturing business whose brand had been enhanced by introducing the inventor's product to the market and now could branch out into other products.

The parties might also conclude that C was better suited to owning and operating the licensing business, while D was better suited to owning and operating the traditional manufacturing business. Under section 731, the appreciated manufacturing business could be distributed without recognition to D, and the appreciated patent could be distributed without recognition to C. Similarly, if there were four original partners, the R partnership could be divided, without recognition, into one licensing partnership owned by C and E and another manufacturing partnership owned by D and F.

Although there are limitations on such restructurings if they are done with property that was originally contributed to a partnership with built-in gain (or loss) — such as the rules applicable to "disguised sales" or "mixing bowls" — those limitations are primarily designed to prevent the use of partnerships as a technique for avoiding the limitations that already existed under section 1031, mainly the requirement that the properties exchanged be of a "like kind" and not be on the excluded list of portfolio assets. If business or investment property qualified for a nonrecognition exchange under section 1031, there would be no reason not to allow a similar exchange through a partnership as long as the mechanical basis adjustment rules were working properly to ensure that built-in gain or loss wasn't inappropriately shifted to a taxpayer with different tax attributes.

We should note that the distribution or split-up of an existing corporation has traditionally been much more limited than in the case of partnerships, mainly because of a concern that the two levels of tax theoretically demanded by the corporate tax system could be avoided if assets that had appreciated while in corporate solution could be transferred in liquidation without the payment of a corporate tax. (In effect, it is the opposite of the concern that exists in partnerships with the shifting of gain that arose before contribution.) That is no longer generally allowed as it was before 1986, when the so-called *General Utilities* doctrine was repealed. Thus, the limitations on corporate divisions have apparently become even more restrictive. Again, those limitations are mainly designed to defend the integrity of the two-level corporate tax system, which today applies only to entities that organize as C corporations.

How Does Section 1031 Compare?

To restate the evident policy underlying the tax code's business formation and reorganization provisions: If the owners of two or more U.S. businesses — or specific business or investment properties — wish to exchange, combine, or restructure (and in some cases divide) their assets because they have reason to believe the new structure will be more efficient or profitable on a pretax basis, the tax law shouldn't impose a cost — in the form of a tax — on the privilege of making that exchange as long as neither party is getting any cash out of the deal, and the parties enjoying nonrecognition remain subject to future tax to the same extent as if the exchange or reorganization hadn't occurred. The possibility that the parties will — incidentally and apparently inevitably — *also* change their business or investment risks and opportunities is generally disregarded, except when that is evidently the exclusive purpose of combining assets using a nonrecognition provision.

Some examples illustrate that the case for such a policy seems even stronger in the case of exchanges under section 1031.

Assume that the R corporation (in the example from the section 351 regulations) had immediately begun manufacturing products using C's patent and determined several years later that it needed to expand. At that time, it might see two options.

First, it could accept an offer to merge into a billion-dollar, publicly traded conglomerate that would use its existing, vacant facilities in Utah for the activities formerly conducted by R in New Jersey and find some other business use for R's New Jersey facilities that were acquired in the merger. After the merger, C and D would no longer be the 25 percent and 75 percent shareholders of a closely held manufacturing business. Instead, they would be exchanging those shares for a much smaller, fractional interest in the publicly traded shares of a billion-dollar company, which might be predominantly engaged in a completely different business.

Secondly, if section 1031 were available, the R corporation (or the R partnership) could arrange to exchange its New Jersey facilities, in a qualified like-kind exchange, for a more suitable facility in Utah, perhaps acquired from the very conglomerate whose merger offer R rejected, in exchange for R's New Jersey plant. In this case, both R and the conglomerate would be using the like-kind exchange rules. Both parties would be swapping assets, and both parties wouldn't be accelerating gain recognition if their facilities had appreciated.

Looking at the assets whose legal ownership changes — the New Jersey and Utah properties — the like-kind exchange and the merger look quite similar. From the perspective of the IRS, anyone looking at the combined tax income statements and tax balance sheets of the two companies should be indifferent to the choice between a merger and a like-kind exchange. By definition, the fair market values of what C and D give up and what they get should be identical (stock for stock, or a New Jersey plant for a Utah plant), and the future depreciation on all assets transferred in both exchanges should be unchanged. Thus, C and D will presumably decide to "merge, exchange, or hold" based on what they believe will produce the best pretax economics for the future. They might believe that their own R corporation, with expanded facilities, will grow and perform better than if it merges into the conglomerate, or the opposite. Of course, no one knows.

From a tax perspective, if the parties think they would be better off economically not merging but merely swapping some of their assets, or if they think they would be better off merging their entire balance sheets, it shouldn't make any difference. The tax results should be the same, although there will obviously be more total taxable income and tax revenue if C and D make the optimal choice as a business matter.

It should also be noted that, in some like-kind exchanges the enhanced economic performance might result from improved performance, say, of the New Jersey property, in the hands of an acquirer who obtained it in exchange for property that did not have any substantial amount of built-in gain. Although the properties have to be of equal value (to avoid partial taxation of any "boot") the amount of gain in the exchanged properties does not have to be the same. As a policy matter, it is irrelevant if it is the transferor of the New Jersey property whose gain is deferred (and preserved in the basis of property he receives), while it is the new owner of that New Jersey property who is able to put that property to better use, as a result of allowing the transaction to proceed.

The fascinating point is that, with the like-kind exchange option, C and D wouldn't be fundamentally changing the nature of their business risks, strategies, or opportunities. They would be engaging in a much more modest restructuring or reorganization. In this example, and many others, the tax policy case for tax-free treatment of the like-kind exchange seems stronger than the case for the merger (or even for the original formation of the R corporation in our prime example).

There is a realistic possibility of improved economic performance in both the merger and the tax-free exchange because C and D will obtain assets that are more suited to their needs. In recognition of that, the tax law doesn't require the acceleration of R's gain on the exchange of its New Jersey facilities for new Utah facilities, whether it is accomplished through a like-kind exchange or a merger. In both cases, the status quo tax-wise is being preserved as if the transaction had never occurred. That is, R's tax basis and depreciation on the New Jersey property will continue to be R's basis and depreciation on the Utah property if it does a like-kind exchange, while the conglomerate's tax basis and depreciation on the Utah property will continue to be its basis and depreciation on its newly acquired New Jersey property. And in the merger, the New Jersey property's tax basis and depreciation, and that of the Utah property, will be unchanged and simply show up on the tax income statement of the newly combined company.

In short, in this case and many others, the like-kind exchange has all the tax policy advantages of a reorganization, with less of a concern (if it is a concern) that the tax system is losing an opportunity to impose a tax on the benefit of changing or diversifying the taxpayer's risks. There is less diversification or economic change, in this example, with the like-kind exchange than with the merger. This illustrates why it is hard to see any justification for taking a more restrictive view toward section 1031 exchanges than is taken with business entity formations or restructurings.

Even as a matter of antitrust policy, it is hard to understand why Congress should be promoting the use of nonrecognition exchanges to create larger and larger companies — which is arguably the prevailing direction of policy in the business entity area — while limiting exchanges used for the restructuring or rehabilitation of existing businesses, or when investors find themselves with direct ownership of assets (not investment securities on the "prohibited" list under section 1031) that no longer match their original plans.

Is There a Counterargument?

Critics of section 1031 might argue that business entity formations and restructurings deserve more favorable treatment, inasmuch as the taxpayer in a like-kind exchange is completely relinquishing ownership of a particular piece of property — like the New Jersey factory — and receiving a completely different property — the Utah factory — without any ongoing connection, joint ownership or operation, or potential real-world synergy between the two pieces of property.

Indeed, if the New Jersey/Utah property swap is a deferred like-kind exchange, it may look very much as if the relinquished New Jersey property is being sold for cash that the "seller" is permitted to reinvest without gain recognition in the Utah property. In contrast, they might argue, although the potential synergy in a business restructuring like the C-D patent exchange may be only a minor factor in the deal, there is at least some. In that case, for example, although C may be discontinuing 75 percent of his existing patent investment, C's apparent motivation for the deal is not only to divest himself of 75 percent of the risks associated with his patent rights and to reinvest the proceeds in a 25 percent interest in D's manufacturing business.

C is also motivated to merge the 25 percent patent stake he has retained into D's manufacturing business, presumably controlled by D as the 75 percent owner. The combination of the patent rights and a manufacturing facility is ostensibly to encourage the single, surviving entity to exploit the synergies that result when a single company owns the exclusive rights to a patent that it has the ability to immediately use in manufacturing a product.

There are two responses to that argument.

First, in reality, there is not any requirement that there be any material amount of potential synergy between two different properties in a business restructuring to enjoy tax-free treatment. In the C-D patent exchange, for example, nonrecognition treatment would be allowed under section 351 even if D's manufacturing facilities were not equipped to use C's patent rights, and R's business plan was to license C's patent to other companies. Also, even if the patent rights were intended to be used by R, nonrecognition would evidently be available even if C's patent rights were worth only $5,000 of R stock, and D's facilities were worth $95,000 of stock in the surviving $100,000 company.

In that event, critics might argue that C was primarily divesting himself of 95 percent of his patent rights (in what could be viewed as a taxable exchange for a 5 percent interest in D's manufacturing business), followed by a bona fide merger of his retained 5 percent patent stake into D's manufacturing business. That is, that substantially all of the C's economic benefits would appear to be resulting from a fundamental change in the nature of his investment, not from any synergies resulting from the fact that his retained 5 percent interest is now owned, controlled and managed by a company with substantial manufacturing facilities.

We note that if D were an existing corporation, and R was being formed as a subsidiary of D, a different set of technical rules would apply, either under section 351 or the reorganization rules, but for the most part there is no minimum "synergy" test. The IRS is not acting like the Federal Trade Commission or the Justice Department to ensure that the combination is in the public interest because it will demonstrably lower consumer prices.

Another example would be a four-person partnership owned by A, B, C, and D, that has built two or more successful lines of business from scratch, say, selling Ford trucks and Mercedes cars, and is later allowed to divide into two distinct partnerships by distributing the Ford dealerships to the AB partnership and the Mercedes dealerships to the CD partnership. Obviously, there is no synergy resulting from a separation of the two businesses. The hoped-for improvement in economic performance will result from the parties' judgment that A and B will be better suited to owning and operating the truck dealerships as a stand-alone entity, while C and D will be better suited to owning and operating the luxury car dealerships as a stand-alone entity.

In all those cases, the potential economic benefits are no less real because they result from there being a better match between the skills, desires, interests, access to capital, or inclinations of the owners and the particular assets they own after the transaction. By the same token, the New Jersey/Utah like-kind exchange has the potential to produce economic benefits by allowing the manufacturer to obtain assets, similar to his existing assets, that are a better match for his business needs.

Second, in all of these cases, one must keep in mind what the alternative would be if the tax law imposed a toll-charge on these business restructurings — whether done as like-kind exchanges or as entity formations, combinations, or divisions.

In the New Jersey/Utah case, the New Jersey owner could avoid gain realization completely by retaining ownership of the New Jersey property and leasing it for 90 percent of its remaining useful life, then using the rents received to pay rents on a similar long-term lease of the Utah property. Similarly, in the C-D patent case, C could have entered a long-term license agreement with D and avoided any realization of gain. Finally, instead of breaking up the ABCD partnership, the parties could agree to special allocations that would give A and B a disproportionate interest (but less than a 100 percent interest) in the profits and losses of the truck dealerships and give C and D a similar disproportionate interest in the car dealerships.

Viewed in this way, insisting on gain recognition in these cases may simply result in a less efficient business deal, or no deal at all, rather than increased tax revenue. The wisdom of the tax law, in all these cases, is realizing that as long as there is no diminution in tax revenues as a result of allowing for a complete separation of ownership — because of the basis rules preserving the tax status quo — the tax law should not stop the parties (and the tax system itself) from realizing the enhanced efficiencies they anticipate from having a better match between the owners of particular assets and the assets themselves.

Importantly, as the rules exist today, this is not a "slippery slope." An owner of publicly traded portfolio stock, commodity futures, inventory, or other assets excluded from section 1031 cannot divest himself from such an investment without recognition of gain, even if he reinvests the proceeds in similar assets — just as a stock portfolio cannot be diversified using section 351 or 721. The policy rationale for differentiating the passively owned, liquid, tradable, and non-business assets from nonrecognition treatment is that there appears to be zero possibility, in such cases, for any improvement in the performance of the exchanged property. While identifying a "zero" case is thus possible, no government agency could accurately predict exactly how much of an improvement in economic performance will result from allowing a like-kind exchange or business restructuring to proceed on a nonrecognition basis.

And even if that were plausible — would the proper policy be to impose a variable toll-charge based on the IRS' judgment of how economically successful a merger or like-kind exchange will be — or simply to wait-and-see and tax the actual operating income of the parties as it arises after the exchange. The key point is that there is no "downside" to the tax system from allowing the exchange to proceed (relative to stopping it in its tracks) and there is at least some possibility of enhanced economic performance from allowing a nonrecognition exchange, either as a like-kind exchange or a business restructuring. In such cases, the tax law wisely recognizes that the purpose of the tax system is to impose a tax on economic income, not to eliminate economic income.

Conclusion

In short, like-kind exchanges and other nonrecognition rules are really addressing different versions of a similar problem.

At one end of the spectrum, with a corporate merger, the billion-dollar acquirer (as well as the target) believe that the target's assets will be more effectively used, developed, or exploited by the acquirer's business than by the target's existing business. To accommodate that, the target's assets (or interests in an entity holding those assets) are exchanged for stock in the acquirer (or partnership interests in an entity organized as a partnership), often substantially diminishing the existing owner's active involvement and very commonly diversifying or otherwise fundamentally changing the nature of his investment risk.

There is nothing wrong with that. The tax code wisely provides that, as long as asset basis is carried over, the business is continued, and the target shareholders remain invested for some period in the acquirer, it makes no sense to put a tax obstacle in the way of this transaction. The tax law is preserving the tax status quo as if the transaction had not occurred, in the hopes that improved economic performance will increase the total, long-term amount of value (and taxable income) in the economy.

With a like-kind exchange, there is a similar economic mismatch between a business or investment asset and its current owner, but the existing owner remains in business or remains as a direct owner of assets "of like kind" to those given up that will likely be deployed in a business or profit-making activity. Thus, he is allowed to exchange his mismatched asset, without acceleration of gain, for another asset that better suits his business or economic needs and capabilities. There isn't necessarily any synergy resulting from the combination of different assets (as existed with C's patents and D's manufacturing plant), but there is a potential synergy from being able to use a different property in the transferor's business or investment activities — or from allowing property to be put to a more productive use than it would be if a tax toll charge were imposed (or if the transaction were restructured to qualify as a long-term lease or loan, not what the parties thought was optimal but to avoid a technical exchange).

In many cases, there is likely to be much less pure "diversification" and more "restructuring" or "rehabilitation" in a like-kind exchange than is permitted in the corporate and partnership world — and it is difficult to see how there could be more diversification than is routinely permitted in the business entity provisions. Overall, that should make these exchanges no less sympathetic and sensible as a tax policy matter, and in many cases more so. ■