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The Uneasy Justification For Special Treatment of Like-Kind Exchanges

ERIK M. JENSEN*

Section 1031 provides generally for nonrecognition of gain or loss on the exchange of property for other property of "like kind." Special treatment of like-kind exchanges has been present in the revenue laws since 1921,² with the form of the current statute, in most respects, unchanged since 1924.³ Although particular issues

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³ See 4 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS A-89 (1984); see also infra note 24.

¹ J.R.C. § 1031(a)(1).

² Section 202(c)(1) of the Revenue Act of 1921 provided in general that no gain or loss was recognized on an exchange of business or investment property for property "of a like kind or use," even if the property received had "a readily realizable market value." Revenue Act of 1921, Pub. L. No. 67-98, § 202(c)(1), 42 Stat. 227, 230. See 4 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS A-88 (1981); see also infra note 24.

³ The nonrecognition principle can be traced to an even earlier time. Although the Revenue Act of 1918 generally required that gain or loss be recognized on a disposition of property, Revenue Act of 1918, Pub. L. No. 65-254, § 202(b), 40 Stat. 1057, 1060, regulations issued under the statute introduced a like-kind concept in the definition of realization:

Gain or loss arising from the acquisition and subsequent disposition of property is realized when as the result of a transaction between the owner and another person the property is converted into cash or into property (a) that is essentially different from the property disposed of and (b) that has a market value. In other words, both (a) a change in substance and not merely in form, and (b) a change into the equivalent of cash, are required to complete or close a transaction from which income may be realized.


regarding section 1031 have elicited considerable commentary in recent years, the nonrecognition principle itself has come to be taken for granted.6

Nothing in taxation should be taken for granted, however. With substantial revision of the Code an almost annual phenomenon in recent years—and with a major restructuring of the Code a distinct possibility—a review of section 1031's purposes is now particularly appropriate.8 This Article undertakes such a review.

Section I of the Article lays the groundwork for the subsequent discussion by briefly describing section 1031 and providing examples of its operation. Section II critically examines the historical justifications for nonrecognition. Not all have aged well, and some were less than robust to begin with. Because the rationales have generally failed to provide a strong basis for distinguishing exchanges of like-kind property from other exchanges of illiquid property. Pub. L. No. 98-369, § 77(a), 98 Stat. 494, 595.


8. None of the major proposals has included a change in the special treatment for like-kind exchanges.
property, section 1031's theoretical foundation is uneasy. The Article reaches the conclusion, nonetheless, that a sufficient basis exists to continue nonrecognition in some form for like-kind exchanges.

I. THE PRESENT STATUTORY FRAMEWORK

The general rule under section 1031 is that:

\[\text{no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.}\]

Section 1031 is not elective, and a transaction that meets the requirements of the section will be governed by its provisions, regardless of the taxpayer's or the government's wishes. Thus, a taxpayer who desires recognition of gain or loss in an exchange must structure the transaction to fall outside the section's boundaries.

Unfortunately, section 1031 provides little in the way of guidelines. It is almost bereft of definitions; it even fails, other than by exclusion, to define property qualifying for like-kind treatment. This lack of guidance has left the development of the controlling

10. See United States v. Vardine, 305 F.2d 60, 65-66 (2d Cir. 1962) (rejecting government's argument that taxpayer had waived nonrecognition under section 1031 by treating property received in like-kind exchange as having a cost basis); Koch v. Comm'r, 71 T.C. 54, 64 (1978) (rules of section 1031 apply automatically); Godine v. Comm'r, 36 T.C.M. 1595, 1597 (1977) (citing Vardine).
11. Section 1031 is applied independently to each taxpayer. It is possible for an exchange to be tax-free for one participant, but not for another. Consider, for example, D's exchange of a truck used in his business for E's truck used solely for recreational purposes. If D will hold his newly acquired truck for use in the business, the exchange will be tax-free to him. However, section 1031 will be inapplicable to E because his recreational vehicle was not held for business or investment purposes.
12. The statute specifically excludes from property qualifying for nonrecognition:
   (1) stock in trade or other property held primarily for sale;
   (2) stocks, bonds, or notes;
   (3) other securities or evidences of indebtedness or interest;
   (4) interests in a partnership;
   (5) certificates of trust or beneficial interests;
   (6) choses in action;
   (7) property not timely identified as exchange property or not received within the statutory time limit; and
   (8) livestock of different sexes.
I.R.C. § 1031(a)(2), (a)(3), (e).
principles to the courts and the Internal Revenue Service.

For property that has been determined to qualify, the statute contemplates two basic types of transactions: (i) exchanges that are solely of like-kind property; and (ii) exchanges of like-kind property that include "boot"—money and other property—added to equalize the exchange. The statutory mechanics of these two situations are described below.

A. EXCHANGES SOLELY FOR PROPERTY OF LIKE KIND

Under section 1031, an exchange is completely tax-free if the property transferred is "property held for productive use in a trade or business or for investment" and the consideration received is solely property of like kind to be held for either business or investment purposes. Any unrecognized gain or loss is merely deferred, not forgiven, with the deferral reflected in the basis of the like-kind property received. The basis of the new property will be the same as the basis that the surrendered like-kind property had in the transferor's hands.

For example, if A exchanges a parcel of investment land, with a basis of $500, for a parcel of B's land with a fair market value of $10,000 to be held by A for investment, A recognizes no gain or loss on the transfer. His basis in the new parcel of land will be $500.

B. LIKE-KIND EXCHANGES WITH BOOT

A transaction is not disqualified from treatment under section 1031 simply because "boot," as well as like-kind property, is in-

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13. This Article considers the tax treatment of exchanges of property of equal value. If an exchange is not for equal value, it may be disguising compensation, a gift, or a dividend from corporation to shareholder. The tax consequences of such a disguised transaction would be determined under other sections of the Code.


15. Although deferred, a gain (or loss) may escape recognition altogether if the new property later declines (or rises) in value. See Portland Oil Co. v. Comm'r, 109 F.2d 479, 487 (1st Cir. 1940):

Congress in enacting [various nonrecognition provisions including that for like-kind exchanges] must have understood the risk that postponement of a recognition of gain might result in the ultimate collection of a lesser tax or none at all. On the other hand, in certain contingencies, it might result in the ultimate collection of greater taxes.


17. Accordingly, if x dollars of gain is not recognized, the basis of the new property will be x dollars less than the basis the property would have had if the exchange had been
volved in the exchange. The transaction, however, is not entirely tax-free.

The applicable principles can be illustrated by the following example. Assume that A exchanges land held for investment for (i) another parcel of land to be held for investment, (ii) a car, and (iii) cash. A must recognize any gain realized on the exchange to the extent of the boot received—that is, the sum of the money and the fair market value of the car (the other property). Thus, if the land received is worth $8,500, the car's value is $1,000, the cash totals $500, and A's basis in his transferred land was $500, he realizes a gain of $9,500. He must recognize the gain, however, only to the extent of the $1,500 boot. The remaining $8,000 of gain is not recognized at the time of the exchange, but is instead reflected in a correspondingly lower basis in the like-kind property received.

If A realizes a loss on the exchange, none of the loss is recognized. A's basis in the like-kind property received will be increased by the amount of the unrecognized loss.

II. THE JUSTIFICATIONS FOR NONRECOGNITION TREATMENT

All nonrecognition provisions fit uneasily within the theoretical structure of the Code. The Code expansively defines gross in-

18. I.R.C. § 1031(b). A taxpayer is generally treated as having received boot, for this purpose, if he transfers property subject to a liability or if the transferee assumes the taxpayer's liability as part of the transaction. I.R.C. § 1031(d). For example, if the property transferred is subject to a $100 liability, the transferor will be treated as having received $100 in cash. However, if both parties to the transaction are relieved of liabilities, the liabilities are netted, and only the net amount is treated as boot. Treas. Reg. § 1.1031(b)-1(c).

19. The gain will be a capital gain because the land was a capital asset in A's hands. If A were to transfer depreciable property in a like-kind exchange with boot, he might have to recognize depreciation recapture. See I.R.C. §§ 1245(b)(4); 1250(d)(4).

20. The aggregate basis of property received by A will equal the basis of the land he surrendered ($500), decreased by the amount of money received ($500), and increased by the amount of any gain recognized ($1,500)—a total of $1,500. I.R.C. § 1031(d). This basis is then allocated among the various items of property, other than cash, received. The car, the other property, will have a basis equal to its fair market value ($1,000). The remainder of the basis ($500) will attach to the land, the like-kind property. I.R.C. § 1031(d). The $8,000 of unrecognized gain on the transfer will thus be offset by the fact that the basis of the like-kind property will be $8,000 less than its fair market value.

21. I.R.C. § 1031(c). Thus, loss is not recognized on the exchange of like-kind property, whether or not boot is received in the exchange.

22. I.R.C. § 1031(d).
come,23 and a sale or exchange of property is presumed to be a taxable event.24 The governing principle throughout Chapter 1 of the Code is that gain or loss on a sale or exchange must be recognized unless a specific statutory exception provides otherwise.25 Exceptions are few,26 and those that do exist are to be strictly construed.27

23. I.R.C. § 61(a) states that, "[e]xcept as otherwise provided in this subtitle, gross income means all income from whatever source derived." The Supreme Court has defined gross income as "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." Comm'r v. Glassshaw Glass Co., 348 U.S. 426, 430 (1955).

24. I.R.C. § 1001(c) states that, "[e]xcept as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized."

The Revenue Act of 1921, which first provided special treatment for like-kind exchanges, had reversed the presumption of taxability. An exchange of property was presumed to be tax-free unless the property received had "a readily realizable market value." Like-kind exchanges were then expressly excluded from taxation even if this threshold for taxability was met. Revenue Act of 1921, Pub. L. No. 67-98, § 202(c), 42 Stat. 227, 230. See H.R. Rep. No. 530, 67th Cong., 1st Sess. (1921), reprinted in 1939-1 (Part 2) C.B. 168, 175-76 [hereinafter cited as 1921 House Report, with page citations to the Cumulative Bulletin]; S. Rep. No. 275, 67th Cong., 1st Sess. (1921), reprinted in 1939-1 (Part 2) C.B. 181, 188-89 [hereinafter cited as 1921 Senate Report, with page citations to the Cumulative Bulletin].


26. The exceptions fall into three basic categories: (i) continuity of investment cases (such as the corporate reorganization provisions of the Code) where the theory for nonrecognition is that only a change in the form of ownership has occurred; (ii) hardship cases (such as the special protection for involuntary conversions of property); and (iii) cases directed at tax avoidance schemes (such as wash sales) where only loss recognition is denied. See M. CHIRELSTEIN, FEDERAL INCOME TAXATION 262 (4th ed. 1985).

27. Treas. Reg. § 1.1002-1(b) provides that: [t]he exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Code only if the exchange is one which satisfies both (1) the specific description in the Code of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule.

Despite this language, there is substantial authority that courts have construed section 1031 liberally. See Starker v. United States, 602 F.2d 1341, 1352-53 (9th Cir. 1979) (noting "long line of cases liberally construing section 1031" and "courts' permissive attitude toward section 1031"); UCLA Comment, supra note 4, at 351 n.6 (noting broad construction of prop-
Although exchanges are presumed to be taxable, exchanges of like-kind property have been afforded nonrecognition for over 60 years.\textsuperscript{28} The historical justifications for this special treatment fall into four sometimes overlapping categories: continuity of investment, administrative considerations, protection against loss recognition, and economic efficiency.

A. CONTINUITY OF INVESTMENT

The strongest justification for nonrecognition is based on the proposition that, after a like-kind exchange, the taxpayer's position is very close to what it was prior to the exchange. Before the exchange he held property of a particular type; following the exchange his investment remains in property of the same type.\textsuperscript{29} His position thus is similar, though not identical, to the position of a holder of assets that have appreciated or depreciated in value.\textsuperscript{30}

1. Taxation of Unrealized Appreciation

Asset appreciation or depreciation is an element in the determination of economic income,\textsuperscript{31} but mere appreciation or depreciation qualifying for nonrecognition, "allowing most exchanges of realty for realty or personality for personality").

\textsuperscript{28} See supra note 2.
\textsuperscript{29} See Koch v. Comm'r, 71 T.C. 54, 63-64 (1978):

The basic reason for allowing nonrecognition of gain or loss on the exchange of like-kind property is that the taxpayer's economic situation after the exchange is fundamentally the same as it was before the transaction occurred . . . . The underlying assumption of section 1031(a) is that the new property is substantially a continuation of the old investment still unliquidated.

See also Magneson v. Comm'r, 753 F.2d 1490, 1496 (9th Cir. 1985) (to same effect), aff'g 81 T.C. 767, 771 (1983).

\textsuperscript{30} See Helvering v. New Haven & S.L.R. Co., 121 F.2d 985, 987 (2d Cir. 1941):
The purpose of such statutes as § 112 [the section of the Revenue Act of 1934 providing nonrecognition to corporate reorganizations and like-kind exchanges] was to make mere formal changes immaterial either for gain or loss; if the taxpayer's succeeding interest was for practical purposes the same, the Act wished to treat any change of value as "unrealized" in accordance with the underlying presupposition of the income tax throughout, that variations in the value of property are negligible unless they take form in some substantially new interest.

\textsuperscript{31} The Haig-Simons definition conceives of income, for an individual, as the "algebraic sum of the individual's consumption expense and accumulation during the accounting period." H. SIMONS, PERSONAL INCOME TAXATION 206 (1938). See Haig, The Concept of Income, in THE FEDERAL INCOME TAX 7 (R.M. Haig ed. 1921) (defining income, probably more narrowly than intended, as "the money value of the net accretion to one's economic power between two points of time"). As Professor Simons noted, "[I]t is hard to argue that one may grow richer indefinitely [through appreciation in value of assets] without increasing one's income." H. SIMONS, supra, at 82 (footnote omitted).
tion has never been included, to any significant extent, in the Internal Revenue Code's computation of gross income. If this principle survives—and there are good reasons why it should—the case for nonrecognition of like-kind exchanges remains defensible, although uneasily so. If this time-honored policy were reversed and unrealized appreciation were taxed, however, the arguments in favor of special treatment of like-kind exchanges would collapse.

Why should a holder of assets whose value has increased not be subject to tax on that appreciation? This unusual example of governmental restraint is attributable to a number of factors.

The restraint can be traced, in part, to *Eisner v. Macomber,* which gave some basis for doubting the constitutionality of taxing unrealized appreciation. This concern, although important at one time, has largely been discredited. If the constitutional issue continues to play a role, it is more because of inertia than because of logic or constitutional exegesis.

Lack of taxpayer liquidity is a far more important reason for protecting unrealized appreciation from taxation. The United States has historically taxed transactions, not economic income, and the Code generally imposes a tax at a time when the taxpayer is in a position to pay it. Congress has determined that a person ordinarily should not be taxed unless he has taken some step to "cash in" on his investment—that is, to convert his holding into

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32. See infra note 44.

33. 252 U.S. 189 (1920). *Macomber* held that a totally proportionate stock dividend was constitutionally immune from tax. The boundaries of *Macomber* have never been clear, but one basis for the decision was that a recipient of such a stock dividend had "not realized or received any income in the transaction." *Id.* at 212 (emphasis added). *Macomber* has been read as holding that the Constitution requires a realization event before there is "income" that can be taxed. *See D. Posn, Federal Income Taxation 148 (1963): "And in the Macomber view such a realizing event is Constitutionally required."

34. *See M. Chirelstein, supra note 26, at 68:

[At present, most tax commentators would be likely to feel that the Congressional taxing power is not seriously restricted to such an implied [realization] requirement, and that Congress is free to treat losses and gains as "realized" pretty much whenever it chooses.


35. However, the merits of the constitutional argument cannot be dismissed entirely. *Eisner v. Macomber,* 252 U.S. 189 (1920), has not been overruled. *See Gabinet & Coffey, The Implications of the Economic Concept of Income for Corporation-Shareholder Tax Systems,* 27 CASE W. RES. L. REV. 895, 933 (1977):

When Justice Pitney [in *Macomber*] held that not all economic gains were income, he placed a severe limitation on congressional freedom to deal freely with the income concept. In concrete terms, he may have ruled out that portion of the Haig-Simons definition of income which treats unrealized increases in net worth as income.

36. *See M. Chirelstein, supra note 26, at 70-71.*
cash or other property equivalent to cash. Without this policy, a tax could be levied on a person with no current ability to pay the tax, thus forcing him to liquidate his investments to meet the tax obligation. The liquidity rationale is crucial in protecting the taxpayer at a time when a tax may be especially burdensome.

Taxing unrealized appreciation would also present an obvious practical difficulty: an annual valuation of assets would be necessary. The valuation process would be an extraordinary burden on taxpayers and an administrative nightmare for the Service. This factor alone is a sufficient justification for the protection of most unrealized appreciation from taxation.

The Code does not consistently adhere to the liquidity and the valuation rationales throughout its provisions; no coherent theory can be expected to account for all aspects of a complex statutory scheme. Taxable events are deemed to occur in some situations even though no cashing-in has taken place. Certain assets, such as publicly traded stock, are so easily convertible into cash that forced liquidation to pay taxes may not create a hardship. And annual valuations, although usually a burden, could be easily accomplished for some classes of assets; publicly traded stock is again an appropriate example. If these are defects in the two ra-

37. One commentator has stated that "income," for tax purposes, "is intended to be an index of a taxpayer's current ability to pay tax." Note, Protecting the Public Fisc: Fighting Accrual Abuse with Section 446 Discretion, 83 Colum. L. Rev. 378, 403 (1983). See also RCA Corp. v. United States, 664 F.2d 881, 888 (2d Cir. 1981) ("Tax accounting ... tends to compute taxable income on the basis of the taxpayer's present ability to pay the tax, as manifested by his current cash flow . . . ."); cert. denied, 457 U.S. 1133 (1982); Schapiro, Tax Accounting for Prepaid Income and Reserves for Future Expenses, 2 Tax Revision Compendium 1133, 1142 (House Comm. on Ways and Means) (1959) (requiring an accrual-basis taxpayer to include prepayments in income at the time of receipt "conforms to a general policy of gearing tax collection to dollars in taxpayer's hands," as does the principle of not taxing unrealized appreciation).

38. See M. Chirelstein, supra note 26, at 70-71.

39. See H. Simon, supra note 31, at 207:

The proper underlying conception of income cannot be directly and fully applied in the determination of year-to-year assessments. Outright abandonment of the realization criterion would be utter folly; no workable scheme can require that taxpayers reappraise and report all their assets annually . . . .

40. For example, non-like-kind exchanges are generally subject to taxation whether or not the taxpayer receives a cash equivalent in the exchange. See supra notes 23-27 and accompanying text.

41. Therefore, the most liquid assets are not eligible for nonrecognition under section 1031. See supra note 12; infra note 53.

42. See M. Chirelstein, supra note 26, at 70; see generally Slawson, Taxing as Ordinary Income the Appreciation of Publicly Held Stock, 76 Yale L.J. 623 (1967) (recommending such taxation).
tionales, however, they are minor defects. Regardless of the extent of tax reform in the near future, there appears to be no possibility that unrealized appreciation will become a significant component of the tax base.

2. Tax Treatment of Like-kind Exchanges

As long as unrealized appreciation escapes taxation, like-kind exchanges are arguably entitled to the same treatment. The analogy between the two cases is not perfect, of course. Whether or not constitutional difficulties remain with taxing unrealized appreciation, the taxation of an exchange of like-kind property would meet any constitutionally imposed realization requirement. In addition, the valuation difficulties with like-kind exchanges are considerably less than with property that has simply appreciated. Nevertheless, unrealized appreciation and like-kind exchanges have a fundamental similarity: in neither case is property converted into cash or a cash-equivalent. The investment of the tax-

45. These factors may not be defects. They can be understood instead as examples of a lack of congruence between theory and practice. See infra notes 65-70 and accompanying text.

44. End-of-year asset valuation for purposes of computing taxable income is currently required in very limited circumstances. See I.R.C. § 1256 (requiring year-end valuation of regulated futures contracts and other "section 1256 contracts").


47. Twenty years after Eisner v. Macomber, 252 U.S. 189 (1920), the Supreme Court in Helvering v. Bruun, 309 U.S. 461, 469 (1940), stated:

While it is true that economic gain is not always taxable as income, it is settled that the realization of gain need not be in cash derived from the sale of an asset. Gain may occur as a result of exchange of property .... The fact that the gain is a portion of the value of property received by the taxpayer in the transaction does not negative its realization. See also Portland Oil Co. v. Comm'r, 109 F.2d 473, 488 (1st Cir. 1940) (nonrecognition exchange under predecessor of I.R.C. § 351 (see infra note 92) gives rise to realized gain or loss in the constitutional sense); Brier, supra note 4, at 401 (to same effect).

When the first statutory protection for like-kind exchanges was provided by the Revenue Act of 1921 (see supra note 2), the 1920 decision in Eisner v. Macomber was fresh in the minds of Congressmen. As a response to Macomber, which is cited in the legislative history, the Act exempted the receipt of stock dividends from taxation. Pub. L. No. 67-98, § 201(d), 42 Stat. 227, 228-29; see 1921 House Report, supra note 24, at 175; 1921 Senate Report, supra note 24, at 187. However, it does not appear that Congress viewed Macomber as an impediment to taxing like-kind exchanges; the committee reports make no reference to Macomber in discussing exchanges of property. See 1921 House Report, supra note 24, at 175-76; H.R. Rep. No. 496, 67th Cong., 1st Sess. (1921), reprinted in 1921-1 (Part 2) C.B. 206, 399 (Conference Committee Report); 1921 Senate Report, supra note 24, at 188-89.

48. See infra notes 74-76 and accompanying text.
payers remain in substantially similar, illiquid property.49

Case law and congressional committee reports are replete with pithy phrases denoting the continuity of investment involved in a like-kind exchange—"paper gain," 50 "theoretical loss," or "theoretical profit," no "cashing in" on appreciation or "closing out" a losing venture.62 A like-kind exchange by itself provides the taxpayer with no cash or other liquid assets63 with which to pay a tax imposed on the exchange,64 and, if a tax were imposed, the taxpayer might be unable to maintain an undiminished investment in similar property.65

Up to this point, the argument for nonrecognition of like-kind exchanges is relatively noncontroversial: section 1031 permits a taxpayer to continue his investment in illiquid property without any diminution for taxes. However, one more theoretical step is required. Other exchanges, such as a parcel of land for a truck, also leave a taxpayer's investment tied up in property that is not a cash-equivalent. If section 1031 is to be theoretically defensible, there must be a principle, consistent with the liquidity rationale,

49. See Brier, supra note 4, who views a like-kind exchange as resulting in no economic realization in the same way that the proportionate stock dividend in Macomber gave rise to no economic realization. Id. at 401; see supra note 33.
52. Portland Oil Co. v. Comm'r, 109 F.2d 479, 488 (1st Cir. 1940) [nonrecognition exchange under predecessor of I.R.C. § 351). See infra text accompanying note 62.
53. The most liquid noncash assets, such as stocks and bonds, are excluded from the category of property qualifying for like-kind treatment. I.R.C. § 1031(a)(2). This exclusion dates from 1923. Act of March 4, 1923, Pub. L. No. 67-545, § 1, 42 Stat. 1560. See Brier, supra note 4, at 400 (footnote omitted):
   A reasonable inference from [the] legislative history is that the like-kind exchange provision, as originally enacted and first amended, was intended to allow nonrecognition on the exchange or receipt of like-kind property of intermediate liquidity and excludes like-kind property under the exclusory clause only if it is highly liquid.
54. See Starker v. United States, 602 F.2d 1341, 1352 (9th Cir. 1979).
A Reagan Administration official, in discussing the underlying purpose of section 1031, noted that "where the taxpayer has received cash or its equivalent, there is no question as to . . . the ability of the taxpayer to pay the tax attributable to any gain realized." Letter from David G. Glickman (Deputy Assistant Secretary of the Treasury for Tax Policy) to Sen. S. I. Hayakawa (Jan. 4, 1982), reprinted in 9 J. REAL EST. TAX'N 349, 350 (1982).
55. See Huskins, Section 1031 Like-Kind Property Exchanges; Possibilities and Pitfalls, 30 S. CAL. TAX INST. 459, 462 (1978):
The like-kind exchange allows for trading up to new property, using one's equity in a property already owned to acquire by exchange another more valuable property, without significant diminution in equity as a result of tax on the previously untaxed appreciation.
that distinguishes like-kind exchanges from other exchanges of illiquid property. 56

The possible bases for distinction are not as strong as the general acceptance of the continuity of investment rationale would indicate, but a couple are worthy of attention. First, limiting nonrecognition to exchanges of like-kind property may allow implementation of the liquidity rationale in an administratively manageable way. As a general proposition, the Code should tax only those exchanges that result in an increase in a taxpayer's liquidity. But the Internal Revenue Service must have workable rules to distinguish qualifying from nonqualifying exchanges. One such rule is to distinguish property of like kind from the rest of the property universe.

A determination that two items of property are of like kind could be construed as a determination that an exchange of the property will have no effect on the liquidity of the two transferors. If nonrecognition were potentially available to exchanges of all property, however, each exchange would have to be analyzed to determine its effects on taxpayer liquidity. Some non-like-kind exchanges would be entitled to protection if the liquidity rationale were fully implemented, but the administrative cost in policing the exchanges on a case-by-case basis would be too high.

This argument is elegant, but not without difficulties. Like-kind exchanges qualifying for nonrecognition may leave a taxpayer in a decidedly more liquid position: consider a taxpayer who exchanges a parcel of real estate with no ready market for an easily marketable parcel. Moreover, if the ultimate purpose of the taxing scheme is to tax only those transactions that result in a marked increase in a taxpayer's liquidity, there are more efficient ways to achieve that result, such as a statutory definition of property deemed to be cash equivalents. 57

Another, stronger ground for distinguishing like-kind exchanges from other exchanges relies not on formal logic, but on

56. This concern is not limited to the continuity of investment rationale. The greatest difficulty confronting most of the rationales for section 1031 is justifying why exchanges of like-kind property should be entitled to nonrecognition while other exchanges should not. See infra notes 80-81, 83 & 98-99 and accompanying text.

57. The statute could simply define those types of property deemed to be cash equivalents, and exchanges of all other items of property could qualify for nonrecognition. Such a scheme would serve not only the continuity of investment rationale, but would also be more economically efficient. See generally USC Note, supra note 5 (arguing for nonrecognition for exchanges of capital assets); infra notes 91-101 and accompanying text.
taxpayer perception: there is an intuitive appeal to treating the recipient of like-kind property identically with a holder of appreciated property. Even if its results cannot be completely defended, no taxing system can or should ignore what seems correct to its taxpayers. In general, the more a system of taxation comports with the perceptions and beliefs of taxpayers, the better compliance with that system will be. In the case of like-kind exchanges, the intuitive appeal of nonrecognition has been bolstered by the long history of the nonrecognition statute and the continuity of investment rationale.

3. History of the Continuity of Investment Theory

Continuity of investment has been a consistent theme in the discussion of like-kind exchanges. In 1934, 13 years after enactment of the first like-kind exchange provision, Congress reviewed the predecessor to section 1031 and determined that the statute should be retained:

[If the taxpayer's money is still tied up in the same kind of property as that in which it was originally invested, he is not allowed to compute and deduct his theoretical loss on the exchange, nor is he charged with a tax upon his theoretical profit. The calculation of the profit or loss is deferred until it is realized in cash, marketable securities, or other property not of the same kind having a fair market value.]

Regulations under the 1939 Code, which were readopted under the 1954 Code, stated that the “underlying assumption of these exceptions [to recognition is] ... that the new property is substantially a continuation of the old investment unliquidated,” and merely formal differences between the old and new property were “not deemed controlling.” In 1984, the Senate Finance Committee, while discussing the special problems created by non-simultaneous exchanges, reiterated the continuity rationale: no profit is “effectively ‘realized’” on a simultaneous like-kind exchange.

Courts interpreting section 1031 and its predecessors have also

58. 1934 House Report, supra note 51, at 564 (emphasis added).
60. Treas. Reg. § 1.1002-1(c).
been persuaded of the rationale's validity. The United States Court of Appeals for the First Circuit, in 1940, stated that such nonrecognition provisions have as their purpose,

to save the taxpayer from an immediate recognition of gain, or to intermit the claim of a loss, in certain transactions where gain or loss may have accrued in a constitutional sense, but where in a popular and economic sense there has been a mere change in the form of ownership and the taxpayer has not really "cashed in" on the theoretical gain, or closed out a losing venture.62

In 1959, the Second Circuit, in Jordan Marsh Co. v. Commissioner,63 found that the primary rationale underlying the statute was to avoid forcing a taxpayer to recognize a paper gain which is still tied up in investment.64

Section 1031, as judicially construed, has diverged from a pure continuity of investment rationale. Some exchanges that in theory should have been protected were not, and other exchanges inconsistent with the theory have nonetheless been afforded nonrecognition treatment. For example, in Starker v. United States,65 the Ninth Circuit recently questioned the validity of the rationale insofar as it relates to a transferor's current ability to pay a tax. The court noted that section 1031 does not protect a transferor from recognition if he sells his property and then, pursuant to a plan, immediately reinvests the proceeds in like-kind property.66 The intervening cash step places the transaction outside the terms of sec-

62. Portland Oil Co. v. Comm'r, 109 F.2d 479, 488 (1st Cir. 1940). See also Trenton Cotton Oil Co. v. Comm'r, 147 F.2d 33, 36 (6th Cir. 1945) (sale and immediate repurchase of oil futures held not a like-kind exchange because taxpayer had cashed-in on his investment); Helvering v. New Haven & S.L.R. Co., 121 F.2d 985, 987 (2d Cir. 1941) (purpose of nonrecognition provisions to treat value as "unrealized" unless change in form of investment occurs); Coastal Terminals, Inc. v. United States, 207 F. Supp. 560, 562 (E.D.S.C. 1962) (citing Portland Oil principle with respect to like-kind exchange), aff'd, 320 F.2d 333 (4th Cir. 1963).

63. 269 F.2d 453 (2d Cir. 1959).

64. Id. at 456 (footnote omitted):
Congress was primarily concerned with the inequity . . . of forcing a taxpayer to recognize a paper gain which was still tied up in a continuing investment of the same sort. If such gains were not to be recognized, however, upon the ground that they were theoretical, neither should equally theoretical losses. And as to both gains and losses the taxpayer should not have it within his power to avoid the operation of the section by stipulating for the addition of cash, or boot, to the property received in the exchange. These considerations, rather than the difficulty of the administrative task of making the valuations necessary to compute gains and losses, were at the root of the Congressional purpose in enacting [the like-kind nonrecognition provision].

65. 602 F.2d 1341 (9th Cir. 1979).

66. Id. at 1352.
LIKE-KIND EXCHANGES

1031 although, in substance, the transferor has continued his investment in like-kind property. 67

Similarly, section 1031 has been criticized because qualifying property has in some cases been too broadly defined. 68 As a result, taxpayers have been afforded nonrecognition despite an exchange that significantly changed the taxpayers’ interests in property—indeed, that significantly increased the liquidity of one of the transferors.

Neither criticism undercuts the continuity of interest rationale. The theory certainly has its weaknesses: if it is to justify different treatment for like-kind exchanges and other exchanges of illiquid property, it is ultimately dependent for its persuasive power on the perceptions of taxpayers. 69 Nevertheless, the theory is not suspect merely because it has been imperfectly implemented. Theory and practice could be brought into alignment by affording nonrecognition to transactions with an intermediate cash step and by more restrictively defining qualifying property. 70

B. ADMINISTRATIVE CONSIDERATIONS

In addition to the mildly persuasive continuity of investment theory, more practical issues have been raised in support of non-

67. See infra note 90 and accompanying text.

68. The regulations under section 1031 are very generous in dealing with exchanges of real property:

[T]he words “like kind” have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not . . . be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material; for that fact relates only to the grade or quality of the property and not to its kind or class.

Treas. Reg. § 1.1031(a)-1(b). Comm’r v. Crichton, 122 F.2d 181 (5th Cir. 1941), has been a particularly heavily criticized case on this point. The Crichton court, interpreting a nearly identical predecessor regulation, allowed nonrecognition for an exchange of property of apparently very different levels of liquidity: an undivided fractional interest in minerals, considered real property under state law, for an undivided interest in a city lot and a hotel. The court stated: “It was not intended [in the regulations] to draw any distinction between parcels of real property however dissimilar they may be in location, in attributes and in capacities for profitable use.” Id. at 182. See 2 B. BITTKER, supra note 2, ¶ 44.2.2, at 44-12 to 44-13 (interpretation of “like kind” as applied to real estate is “extraordinarily liberal, not to say lax”).

69. See supra text between notes 57 & 58.

70. Both corrective devices have been suggested, implicitly or explicitly. See, e.g., 2 B. BITTKER, supra note 2, ¶ 44.2.2, at 44-12 (noting inconsistency of practice in real estate exchanges with theory of statute); UCLA Comment, supra note 4, at 365-66 (recommending rollover provision permitting nonrecognition if proceeds reinvested in like-kind property within specified period).
recognition. Administrative difficulties, it has been suggested, would increase if like-kind exchanges were subject to taxation. In particular, taxation would require property valuation in difficult circumstances and could exacerbate various compliance problems.

1. Difficulty of Valuation

A concern over the administrative difficulty of valuing property is present in the earliest legislative history of the like-kind provision: the statute, by providing for nonrecognition and a substituted basis, eliminates any need for valuation. For example, as part of its 1934 review, the House Ways and Means Committee noted:

The Treasury Department states that its experience [with the like-kind exchange statute] indicates that this provision does not in fact result in tax avoidance. If all exchanges were made taxable, it would be necessary to evaluate the property received in exchange in thousands of horse trades and similar barter transactions each year. The committee does not believe that the net revenue which could thereby be collected . . . would justify the additional administrative expense.

Citing the legislative history, some courts have given difficulty of valuation as a primary purpose behind section 1031 and its predecessors. The valuation rationale, however, has fatal shortcomings in its support of special treatment for like-kind exchanges. First, valuation is not an insuperable burden from the standpoint of taxpayers. Parties entering into a like-kind exchange place a value on the property they are surrendering and receiving. The valuation may be implicit, but it is made.

The valuation difficulties in a like-
kind exchange are thus of considerably less magnitude than those that would exist with a tax on unrealized appreciation.\textsuperscript{76}

Even more damaging to the valuation rationale is that explicit valuation is required in many, perhaps most, like-kind exchanges. Whenever boot is involved, the transaction is not completely tax-free, and valuation is necessary to compute the tax consequences of the exchange.\textsuperscript{77} Only if the recipient of the boot is willing to treat the entire amount of boot as gain will he escape valuing the like-kind property received in the exchange.\textsuperscript{78} Since boot will be involved in all exchanges where the items of like-kind property are not equal in value, valuation may be the rule rather than the exception.\textsuperscript{78}

Finally, the valuation argument fails to distinguish like-kind exchanges from other property exchanges. Nothing in the nature of like-kind exchanges imposes special valuation difficulties, a fact that has been duly noted by the courts. As the court in \textit{Jordan Marsh} stated, if valuation were really an insoluble problem, all exchanges of property—not only those of like kind—should be provided nonrecognition.\textsuperscript{80} Instead, the law appears to be moving in
the direction of requiring valuation in more and more cases.81

2. Compliance Problems

Another administrative justification advanced for continuing nonrecognition of like-kind exchanges is that taxation would (i) lead to an enhanced underground barter system, the results of which would go unreported, and (ii) result in increased taxpayer attempts to whipsaw the Internal Revenue Service by not reporting gain on an exchange but later, after the statute of limitations on the exchange has run, claiming a stepped-up basis for the property.82

Taxing like-kind exchanges would result in compliance problems, just as all taxation does. More legal requirements inevitably lead to some evasion of those requirements. But the price of perfect compliance is no system of taxation. Noncompliance in the underground cash economy could be eliminated by not taxing cash

81. See, e.g., I.R.C. § 132, as added by the Tax Reform Act of 1984, which provides for exclusion from gross income of certain employee fringe benefits. If a fringe benefit does not fit within the statutory exclusion, it must be valued and taxed. See I.R.C. § 61(a)(1). The practical difficulty of valuing such fringe benefits as travel on a company plane is apparent: from the temporary regulations issued under section 61. See Temp. Treas. Reg. § 1.61-2T(g) (filed Dec. 18, 1985); see also Treas. Reg. § 1.1001-1(a) (property received in exchange must be valued except in "rare and extraordinary" circumstances); Warren Jones Co. v. Comm'r, 524 F.2d 788 (9th Cir. 1975) (very limited role for open transaction method of reporting gain because property received must be valued except in "rare and extraordinary" circumstances).

82. See AMERICAN BAR ASSOCIATION TAX SECTION, REPORT OF TASK FORCE ON SECTION 1033 SIMPLIFICATION (1983) (recommending that definitions of property qualifying for non-recognition under I.R.C. §§ 1031 and 1033 be conformed).
transactions; noncompliance in already existing underground barter systems could be eliminated by not taxing exchanges of property generally. There is no evidence that taxable *like-kind* exchanges would be particularly conducive to tax evasion.\textsuperscript{83}

The whipsawing concern is also largely chimerical. A taxpayer who innocently fails to report a taxable exchange may, in some limited circumstances, have the benefit of a tax-free step-up in basis.\textsuperscript{84} That possibility is inherent in any system of taxable exchanges and statutes of limitations. For a taxpayer who intentionally enters into a transaction to induce a whipsaw effect, however, the nonreporting of the exchange has another name: fraud. Fraud has no statute of limitations.\textsuperscript{85}

\section*{C. PROTECTION AGAINST LOSS RECOGNITION}

When Congress reviewed the nonrecognition principle in 1934, one concern was protection of revenue. Had like-kind exchanges been taxed at that time, the heart of the Depression, it was probable that "claims for theoretical losses would . . . exceed any profits which could be established."\textsuperscript{86} Taxpayers, after exchanging like-kind property, would have been able to retain their investment in property of a particular sort and report theoretical losses on the

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\textsuperscript{83} Indeed, the two areas where like-kind exchanges have been most common, real estate and vehicle trade-ins, appear ill-suited to evasion. Both types of property have extensive recordkeeping requirements for nontax purposes, and documentation is the enemy of tax evasion.

\textsuperscript{84} The circumstances may be very limited. In determining basis, a transferee of property is not estopped by errors of the transferor. See Florida Mach. & Found. Co. v. Fahs, 168 F.2d 907, 959 (5th Cir. 1948). But the transferor is not free from the effects of his own mistakes, and the Commissioner, notwithstanding the running of the statute of limitations, may assess an additional tax for the year of the exchange if the transferor later uses a stepped-up basis. See I.R.C. § 1312(7); B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 3.11, at 3-46 & 3-46 n.115 (1979).

\textsuperscript{85} 1.R.C. § 6501(c)(1)—(c)(3).

\textsuperscript{86} 1934 House Report, supra note 51, at 564. See Guerin, supra note 4, at 559 n.32.

The legislative history of the Revenue Act of 1921 reflects a similar concern but with respect to all exchanges of property. The statute provided for nonrecognition except upon the receipt of property that had a "readily realizable market value." See supra note 24. It was felt this provision would "considerably increase the revenue by preventing taxpayers from taking colorable losses in wash sales and other fictitious exchanges." 1921 House Report, supra note 24, at 178; 1921 Senate Report, supra note 24, at 189. The statute was changed in 1924 because of the administrative problems in dealing with the "readily realizable market value" concept and the lack of a fair and consistent application. See 1924 House Report, supra note 24, at 250-51; 1924 Senate Report, supra note 24, at 275; see also Duhl, supra note 4, at 990.
Continuation of the nonrecognition principle prevented that result—or so it was thought—for the government's benefit. This justification for nonrecognition is a historical artifact. Today, in an inflationary economy, with real estate prices in particular on the rise in the last two decades, section 1031 is more beneficial to taxpayers than to the government. Moreover, when loss recognition is desired, structuring a transaction to avoid like-kind treatment is generally easy, as it was in 1934. For example, inserting an intermediate cash step in the exchange has generally been sufficient to result in taxable treatment. Rather than serving

87. Even worse, taxpayers could have structured exchanges followed by reexchanges of the same properties. These back-to-back exchanges, the equivalent of wash sales, would preserve ownership while the taxpayers reported losses on the first “exchange.” See Leslie Co. v. Comm'r, 539 F.2d 943, 947 n.13 (3d Cir. 1976) (Commissioner argued that preventing colorable losses in wash sales was one of original purposes of section 1031).

88. Guerin, supra note 4, at 559 n.32.

89. It is easy if the taxpayer has really relinquished his property in the exchange. In the most egregious cases, however, where the taxpayer acquires identical property (see supra note 87), the Commissioner has another weapon in his arsenal to prevent loss recognition. Even though the wash sales provision of the Code (I.R.C. § 1091) applies only to stocks and securities, he can argue that in substance no exchange has occurred. See, e.g., Horne v. Comm'r, 1 T.C. 250 (1945), where the taxpayer sold for $1,000 a commodities exchange seat he had acquired for $24,000 and then acquired an identical seat for $1,100. The Tax Court disallowed the loss:

[T]he persuasive fact is that after consummation of the plan which petitioner had put into operation eight days previously he stood in exactly the same position as before, except that he was out of pocket $100. . . . One “seat” was exactly like another . . . . Petitioner never divested himself of the rights which he enjoyed by reason of his membership in the exchange, and never intended to do so. Although he went through the form of purchasing one certificate and selling another, the result was the same as if he had exchanged his certificate for that of another member.

Id. at 255-56.

90. It is clear that an intervening cash step was intended from the beginning to be fatal to nonrecognition. The following colloquy on the House floor during consideration of the Revenue Act of 1924, between House Ways and Means Committee Chairman Green and Congressman Fiorello LaGuardia, is instructive:

LaGuardia: Under this paragraph [section 202(c)] is it necessary to exchange property? Suppose the property is sold and other property immediately acquired for the same business. Would that be a gain or loss, assuming there is greater value in the property acquired?

Green: If the property is reduced to cash and there is a gain, of course it will be taxed.

LaGuardia: Suppose that cash is immediately put back into the property, into the business?

Green: That would not make any difference.

65 Cong. Rec. 2798 (1924). See also Carlos v. United States, 385 F.2d 238, 241, 243 (5th Cir. 1967) (receipt of cash removed transfer from section 1031 even though parties intended an exchange and, on facts, "result is obviously surer").
a useful social policy, providing for mandatory nonrecognition of loss under section 1031 serves as a trap only for the unwary and the ill advised.

D. ECONOMIC EFFICIENCY

The last historical rationale for nonrecognition has, as its basis, a concern for economic efficiency. In 1921, at the same time that nonrecognition was provided for like-kind exchanges, similar protection was granted for (i) exchanges of stock or securities made pursuant to corporate reorganizations and (ii) other property transfers made pursuant to the predecessor of Code section 351. Nonrecognition in these cases, Congress concluded, "permit[ted] business to go forward with the readjustments required by existing conditions," by removing tax obstacles to the free flow of investment capital.

The economic argument in favor of nonrecognition takes the following form: Taxation is a cost of doing business. Taxes, by potentially distorting the operation of the marketplace, increase the likelihood that assets will not be used in the most economically efficient manner. For example, although taxpayer A can put an asset to more efficient use than taxpayer B, the current owner of the asset, B may be unwilling to make the transfer because of the tax consequences of the transaction. The asset is thus locked-in to a relatively inefficient use, a result the United States taxing system generally disfavors.

91. See supra note 2.
92. I.R.C. § 351(a) in general provides that no gain or loss is recognized on transfers of property to a corporation in exchange for stock and securities of the corporation if the transferors are in control of the corporation (as defined in I.R.C. § 368(c)) immediately after the exchange.
93. 1921 Senate Report, supra note 24, at 189; see 1921 House Report, supra note 24, at 176.
94. It is presumably for this reason that section 1031 is limited to exchanges of business or investment property. See supra text accompanying note 9. Even though an exchange of nonbusiness property may share many of the characteristics of a qualifying exchange, facilitating nonbusiness exchanges is generally a lower societal priority. Cf. I.R.C. § 1034 (providing for nonrecognition of gain on timely rollover of proceeds from dispositions of principal residences).
95. If B is an individual, the effect of gain recognition may seem particularly severe. If B holds the property until his death, the basis of the property in the hands of his beneficiaries will be stepped-up, tax-free, to the fair market value at that time. I.R.C. § 1014(a). See Huskins, supra note 55, at 462.
96. See NYU Note, supra note 4, at 588-92. For example, the Supreme Court has explained the special effective tax rates applicable to net capital gains as relief "from ... excessive tax burdens on gains resulting from a conversion of capital investments, and to
Because of section 1031, exchanges of property take place that would not otherwise occur, and, as a result, some inefficiently used assets are put to relatively efficient uses by their new owners. Viewed in isolation, these exchanges appear to spur economic activity, thereby increasing tax revenues.97

The economic efficiency attributable to section 1031 is illusory, however. The special treatment of exchanges of property of like kind introduces its own distortions into the market. Apart from the continuity of investment rationale, the classification of property into like-kind and non-like-kind categories is arbitrary;98 the economic justification for section 1031 provides no theoretical basis for singling out like-kind exchanges for special treatment. By providing for nonrecognition for only some exchanges, the tax system encourages overinvestment in property suitable for such exchanges. Furthermore, the system introduces a new lock-in effect: section 1031 encourages taxpayers to hold property until a like-kind exchange can be effected although more profitable investment alternatives may exist elsewhere.99

Rather than promoting the free flow of investment capital, which would be best served by nonrecognition for all transfers of business or investment property,100 the statute thus promotes the flow of a limited category of assets, property of like-kind. Moreover, the statute diverts that flow to the barter market, a relatively inefficient mechanism for allocating scarce resources. Property exchanges generally have higher transaction costs, for example, than remove the deterrent effect of those burdens on such conversions.98 Burnet v. Harmel; 287 U.S. 103, 106 (1932).

The "lock-in" effect in general is discussed in M. CHIRELSTEIN, supra note 26, at 271-75. The effect can be particularly troublesome in years with high rates of inflation, such as the 1970s. The increased interest in section 1031 in recent years probably stemmed from the economic conditions of the times. See Friedman, Exchanges of Like-Kind Property, 31 Tulane Tax Inst. 2 (1981).

97. The argument has been made most vigorously with respect to real estate exchanges and, in particular, the passage of undeveloped property from weak hands to strong hands. The "seller" is the owner of undeveloped property that he has neither the means nor the inclination to develop. If he is required to recognize gain upon disposition, he might well retain the property to his death. See supra note 95. The "buyer" is frequently a developer who will aggressively improve the acquired property, with the attendant beneficial effects on the economy. See American Bar Association Tax Section, supra note 82.

98. Even with the continuity of investment rationale, the justification for the classification is not completely convincing. See supra notes 45-70 and accompanying text.

99. USC Note, supra note 5, at 371-72.

100. See generally id. (arguing for extension of nonrecognition on grounds of economic efficiency). Full development of the arguments in favor of nonrecognition for all such exchanges is beyond the scope of this Article.
transfers through use of cash or other mediums of exchange.\textsuperscript{101}

III. CONCLUSION

The flaws in the rationales for section 1031 are surprisingly serious considering the long history of the section and its predecessors. The case for nonrecognition is uneasy not because continuity of investment, valuation difficulties, compliance issues, and economic efficiency are empty concerns. It is uneasy because those historical rationales at best imperfectly justify distinctive treatment for one limited class of property exchanges.

Nonetheless, the case for nonrecognition does exist, and section 1031 does have history on its side. A like-kind exchange provides continuity of investment in illiquid property. Perhaps continuity of investment and economic efficiency would both be better effected by extending nonrecognition to all exchanges of illiquid business and investment property. If that step is not to be taken, however—and it is doubtful that Congress would seriously entertain such a proposal—the intuitive appeal of distinctive treatment for like-kind exchanges remains.

\footnote{101. \textit{Id.} at 365-71.}