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By Sanford M. Guerin*

Introduction

In an era characterized by rapidly appreciating real estate, rising interest rates, and an inflationary economy, an investor may wish to cash out an appreciated real estate investment to obtain greater liquidity while remaining in the real estate market as a hedge against inflation. The investor generally utilizes three basic methods to dispose of appreciated property while partially or totally reinvesting in new property: a section 1031[1] tax-free exchange; a full recognition straight sale followed by reinvestment; and a section 453 installment sale followed by reinvestment. This article illustrates a fourth method, the hybrid 1031/453 transaction, a misunderstood and underutilized method of disposition, which may be the most effective tax planning tool available to an investor wishing to trade down his net real estate holdings.[2]

A typical "tax-planned" section 1031 exchange involves trading low value and low basis property for heavily encumbered high value property. In addition to the increased leverage and nonrecognition of realized gain, another motive for such an exchange is acquiring an increased depreciable basis.[3] Since trading up pursuant to section 1031 does not ordinarily involve

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1. Except as otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended.

2. Subsequent to the writing and prior to the publication of this article, Congress began considering the issues contained herein in the Installment Sales Revision Act of 1980. *See Congressional Record*, H.R.6883, 96th Cong., 2d Sess., 126 CONG. REC. H3962 (1980). Portions of this article are included in the House Ways and Means Committee Report concerning the enactment of H.R. 6883.

3. This increase is partially due to the assumption of liability to which the acquired property is subject. Section 1031(d) specifies the formula for determining the basis of property received in a like-kind exchange: Basis of the property exchanged *plus* gain recognized *minus* money received *minus* loss recognized. Treas. Reg. § 1.1031(b)-1(c) (1956), and Treas. Reg. § 1.1031(d)-2, ex. 2 (1956), provide for the offsetting of liabilities on the exchanged properties. The taxpayer in the regulation's example transferred property subject an an $80,000 liability, but received, in exchange, property subject to a $150,000 liability. As a result of receiving property subject to a greater encumbrance, the taxpayer was deemed not to receive "boot" (*see* note 7 *infra*) with respect to the $80,000 of debt relief. (It should be noted that the receipt of $40,000 cash by the taxpayer did constitute boot because the negative mortgage balance of the taxpayer did not offset the money or other nonlike-kind property received.) The basis of the property received by the taxpayer was increased by the taxpayer's negative mortgage balance. In reaching this result, the liability on the property received was initially added to the basis of the transferred property (considered as other property under Treas. Reg. § 1.1031(d)-1(a) (1956)). Then the liability on the property transferred was subtracted from the resulting sum (considered as money received for purposes of this computation). (I.R.C. § 1031(d))

a cashing out of the investment, the desire for liquidity is not met.[4]

If an investor wishes to completely liquidate his investment, a straight sale must be considered. The straight sale of property for cash followed by reinvestment of the proceeds results in full gain recognition upon disposition of the old property under section 1001 principles and a fair market value (FMV) cost basis in the reinvestment property pursuant to section 1012.[5]

Between these extremes lie two other tax planning alternatives. First is the installment method of reporting gain under section 453(b),[6] which while requiring full gain recognition, permits a taxpayer to spread the reporting of the gain ratably over the term of the installment payments. Although the taxpayer may then reinvest in other property at any time, the reinvestment must be accomplished with after tax dollars. The basis of the newly acquired property is the FMV under section 1012.

Second is the hybrid 1031/453 transaction. This transaction generally involves the reverse situation of the typical "tax-planned" section 1031 exchange; the taxpayer trades higher value property for lower value property, accompanied by the receipt of nonlike-kind property, cash, or notes. The "boot"[7] received in the hybrid 1031/453 transaction includes cash, nonlike-kind property, and the purchaser/exchangee's notes which represent payment for the value differential of the properties. This transaction is basically a substitute for installment reporting with one important variation. In the hybrid 1031/453 transaction, the reinvestment property must qualify as like-kind property[8] and is considered a payment in the year of sale (PYOS)

4. If the taxpayer refinanced his property prior to the exchange, however, he could cash out to that extent, possibly without gain recognition. Woodsam Assocs., Inc. v. Commissioner, 198 F.2d 357 (2d Cir. 1952). Such a transaction, though, may be subject to attack under the step transaction or business purposes doctrine.

5. Immediate gain recognition may be avoided if the sale is designed as a deferred payment sale qualifying for open transaction reporting. Burnett v. Logan, 283 U.S. 404 (1931). In such a situation, a taxpayer would not report any gain, as payments are received from the purchaser, until the aggregate payments exceed the taxpayer's adjusted basis in the old property. Each payment, or portion thereof, received after the taxpayer has recovered his basis must be reported in full. In an open transaction, a taxpayer could reinvest in another property after payments have been received which are sufficient to complete the new purchase. The basis in the new property would be the FMV cost basis under § 1012.

6. Gain from the sale or other disposition of real property or from the casual sale or other disposition of noninventory personal property for a price greater than $1000 may be reported on the installment method under § 453(b). Under the installment method, the taxable portion of each installment payment equals:

Gross profit/Total contract price × Installment payment = Amount to be reported as gain in the year received. *See* text accompanying notes 24-29 *infra*.

7. "Boot" is a word of art derived from § 1031(d) and Treas. Reg. § 1.1031(b)-1 (1956) to mean the receipt of money and "other property" (*i.e.*, nonlike-kind property) which must be recognized to the extent of realized gain.

8. Like-kind property is defined as property of the same nature or character as the transferred property and not as property of the same quality or grade. The following are examples of like-kind property: improved and unimproved realty, Treas. Reg. § 1.103(a)-1(b) (1956); urban realty and a ranch, Treas. Reg. § 1.1031(a)-1(c) (1956); a fee interest and a 30-year leasehold interest in realty, *id.*; and a fee interest and a mineral interest in realty, Commissioner v. Crichton, 122 F.2d 181 (5th Cir. 1941).

Like-kind property must be held by the taxpayer for productive use in a trade or business or for investment to fall within the provisions of § 1031(a). Further, § 1031(a) specifically excludes inventory, stocks, bonds, and similar interests as like-kind properties entitled to nonrecognition treatment.

under the thirty percent test of section 453(b)(2)(B).[9] Thus, the reinvestment is integrated with the sale of the old property into a single plan, with the taxpayer perhaps selecting the reinvestment property and the purchaser acquiring and then exchanging the selected property with the taxpayer for the old property.[10]

The taxpayer in a 1031/453 hybrid transaction generally receives the purchaser/exchangee's notes[11] which he may elect to report on the installment method assuming that the requirements of section 453 are met.[12] The taxpayer who qualifies under both section 1031 and section 453 receives two advantages over conventional installment reporting. First, due to the application of section 1031, if the value of the like-kind reinvestment property exceeds the adjusted basis of the old property, the realized gain will not be fully recognized — the gain is recognizable only to the extent of the boot. This reduced gain recognition is effected by applying a smaller profit reporting percentage to each payment received.[13] Second, the reinvestment is accomplished with tax-free dollars.[14]

There is one disadvantage to the partial nonrecognition achieved in the hybrid 1031/453 transaction. As with all nonrecognition provisions, the basis of the reinvestment property reflects the nonrecognized gain and is less than the FMV of the newly acquired property to the extent of the nonrecognized gain.

The following discussion initially sets forth the basic principles of sections 1031 and 453. The interaction of these sections is then analyzed, with special attention given to the Service's analysis of the hybrid 1031/453 transaction in Revenue Ruling 65-155[15] and also the Tax Court's analysis in *Clin-*

9. Rev. Rul. 65-155, 1965-1 C.B. 356, 357.

10. In order to obtain the benefits of § 1031, the taxpayer must avoid making the purchaser his agent in the transaction. The typical § 1031 exchange consists of the taxpayer selecting the property he wishes to receive, then arranging the purchase terms with his exchange partner, followed by the exchange partner purchasing the taxpayer's property, and the taxpayer receiving the selected property in return. If the purchaser/exchangee is deemed to be the taxpayer's agent, the transaction will be restructured into the form of an outright sale by the taxpayer of his property followed by the taxpayer purchasing the selected property. *See* Alderson v. Commissioner, 317 F.2d 790, 792 (9th Cir. 1963), where the Service advanced such an argument. This interpretation of the transaction, of course, negates the exchange requirement of § 1031.

The courts have been reluctant to find the purchaser/exchangee to be the taxpayer's agent in the typical like-kind exchange reasoning that the purchaser/exchangee is at risk since the transfer of the selected property to the taxpayer is not strictly guaranteed. *Id.* at 793. The Service seems to have accepted this theory in Rev. Rul. 77-297, 1977-2 C.B. 304, 305 (citing *Alderson*) while in addition emphasizing that the purchaser/exchangee was not the taxpayer's agent since he could not look to the taxpayer for specific performance upon default.

The court in *Alderson*, at 793, and the Service in Rev. Rul. 77-297, at 304, have not regarded the taxpayer's agency for the purchaser/exchangee by selecting the property as vitiating the application of § 1031 to the transaction.

11. The notes are considered boot for the purposes of § 1031.

12. *See* text accompanying notes 17-20 *infra*. The payments received in the year of sale cannot exceed 30% of the selling price. I.R.C. § 453(b)(2)(B).

13. *See* text accompanying notes 33-35 *infra*. Section 453 is altered to take account of gain recognized—not the gross profit.

14. The nonrecognition provisions of § 1031(a) permit the reinvestment in like-kind property without recognizing any realized gain at the time of exchange.

15. *See* text accompanying notes 33-35 *infra*.

ton H. Mitchell.[16] By analyzing *Mitchell* in conjunction with Revenue Ruling 65-155, the problems inherent in each approach are illustrated. Moreover, the effect of the profit reporting percentage upon the like-kind property received under section 1031, the proper computation of PYOS, and the correct basis allocation formulas to be applied to the like-kind property and the buyer's notes are considered. Finally, suggested alternatives to the Service's approach in Revenue Ruling 65-155 are discussed in the context of two-party and multi-party exchanges.

I. PRINCIPLES OF SECTION 1031

Designed as a tax relief measure, section 1031 has received widespread acceptance in recent years in the area of real estate investments. The provision is a nonrecognition section, drafted to provide relief when investment property is exchanged for property of a "like-kind."[17]

Section 1031 requires that the exchanged properties be: (1) of like-kind; and (2) held for productive use in the taxpayer's trade or business or held for investment.[18] This discussion assumes that these requirements are satisfied, therefore, they are not addressed. Section 1031 is based on the equitable notion that a taxpayer who does not completely "cash in" his investment, but merely changes its form, may not receive cash or other assets of sufficient liquidity to enable him to satisfy the tax liability if the transaction required recognition of gain.[19] It should be noted that the taxpayer does *realize* gain. With the exception of boot, however, he does not *recognize* gain at this time. Instead, the gain realized but not recognized is reflected in the taxpayer's basis adjustments in the property which he receives.[20]

Although compliance with section 1031 appears relatively simple, complications surface where nonlike-kind property or boot is received in addition to the like-kind property. Since few, if any, real estate transactions involve properties of identical value and liabilities, this type of transaction is the rule rather than the exception. Indeed, there is little reason to undertake such a transaction unless the taxpayer merely wants different property for purely nontax, business reasons.

Consequently, the receipt of nonlike-kind property brings the transaction under a special provision of section 1031 whereby nonrecognition of gain is still available, but only as to the like-kind property received in the exchange.[21] Boot, received in the form of nonlike-kind property, does not

16. Mitchell v. Commissioner, 42 T.C. 953 (1964).

17. *See* note 8 *supra*.

18. This is a factual question of intent determined by the actions of the taxpayer with respect to the property. Thus, the purchaser in the typical like-kind exchange described in note 10 *supra*, is not deemed to hold the property acquired for the productive use in a trade or business or for investment since he acquired the property for immediate exchange. Rev. Rul. 77-297, 1977-2 C.B. 304, 305.

19. *See* Treas. Reg. § 1.1002-1(c) (1957): "The underlying assumption [of § 1031] is that the new property is substantially a continuation of the old investment still unliquidated . . . ."

20. I.R.C. § 1031(d) provides for a carryover basis in the exchanged property as explained in note 3 *supra*. Therefore, upon the subsequent sale of the exchanged property in a taxable transaction, the realized gain that previously was nonrecognized will finally be recognized.

21. I.R.C. § 1031(b): "If an exchange would be within the provisions of subsection (a) . . .

qualify for nonrecognition. Thus, gain must be recognized to the extent of boot received.

The regulations are specific on what constitutes boot.[22] Money is obviously nonlike-kind property, as is any evidence of the purchaser/exchangee's indebtedness. Although mortgage relief to the seller/exchangor is deemed to be money received, and, therefore, boot, the regulations allow such mortgage relief to be offset by any mortgage burden (whether taken subject to or assumed) acquired by the seller/exchangor.[23] In other words, included among the boot to the seller/exchangor is the net positive mortgage relief, if any, which he receives.

In coupling net positive mortgage relief with additional consideration in the form of the purchaser/exchangee's notes, it is entirely feasible that, despite not receiving any cash, the seller/exchangor may face a substantial tax liability on the boot received. Additionally, it is also possible that the seller/exchangor will receive insufficient cash to satisfy the resulting tax liability. Although benefitting by being able to increase his basis in the new property by any gain recognized on the exchange, the seller/exchangor who has agreed to accommodate the buyer/exchangee's desire for deferred payments may face a substantial liquidity problem.

II. PRINCIPLES OF SECTION 453

The seller/exchangor's tax predicament under section 1031 is no less perplexing than the analogous situation of a sale of property on a deferred payment plan. Even though varying degrees of sophistication exist in such arrangements, they all contemplate the payment of the purchase price over a specified period of time. Under pre-section 453 taxing schemes, the seller was required to immediately recognize his entire gain regardless of the economic fact that he did not receive the entire amount in the year of sale.[24]

It was precisely for such circumstances that section 453 was intended to provide some measure of relief. While not technically a nonrecognition provision, it nevertheless allows *deferral* of gain recognition where the transaction fits within various criteria designed to strike an equitable balance between general tax principles and the economic realities of installment or deferred payment transactions.[25] Since, by definition, the taxpayer who sells on an installment basis takes time to receive all his profits, he should be allowed to report those profits by recognizing gain in proportion to the total amount of gain to be recognized.

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if it were not for the fact that the property received in exchange consists not only of property permitted . . . to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property."

22. Treas. Reg. § 1.1031(b)-1(b) to -1(c) (1956).

23. *See* note 3 *supra*. *See also* Treas. Reg. § 1.1031(b)-1(c), (d)-2, ex. 2 (1956).

24. I.R.C. § 1001(c) states: "Except as otherwise provided . . . the entire amount of the gain or loss . . . on the sale or exchange of property shall be recognized." The amount of gain would equal the amount realized, irrespective of when received, less the adjusted basis of the property sold or exchanged.

25. I.R.C. § 453(a)-(b) provide for the proportionate recognition of gain upon receipt of installment payments in a given taxable year.

Conventional installment reporting is allowable when PYOS do not exceed thirty percent of the selling price.[26] Cash and other property received are included as PYOS in addition to the mortgage relief in excess of basis.[27] Expressly *excluded* from PYOS is evidence of the purchaser's indebtedness.[28] This exclusion is a logical extension of the installment reporting rationale because part of the seller's profit is represented by the buyer's note, and the seller typically will not collect on the note until its maturity date. Further, the seller need not count the note as a PYOS since he will not receive the cash necessary to pay the consequent tax liability until some future date.

If the taxpayer satisfies the thirty percent test, he then turns to another formula to determine the proportion of each installment payment that must be reported as gain. Section 453(b) provides the formula for calculating the percentage: payments received are reported as gain in proportion to the ratio that the gross profit bears to the total contract price.[29] In theory, the proportion not reported as gain represents a return of the seller's capital or basis. For example, if the taxpayer sells property with an FMV of $100 and an adjusted basis of $50 and receives $30 in cash plus $70 in purchaser's notes, the taxpayer can elect section 453 since the PYOS ($30) are not greater than thirty percent of the $100 selling price. The taxpayer's gross profit equals his realized gain of $50, and the total contract price equals the $100 selling price. Thus, each payment that the taxpayer receives, including the $30 received in the year of sale, has a gain component of fifty percent ($50 gross profit/$100 total contract price). If the purchaser assumes a liability of the taxpayer for $20, the total contract price would be $80, and the gain component of each payment would be 5/8 ($50 gross profit/$80 total contract price). The balance of each payment represents a return of the taxpayer's basis.

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26. I.R.C. § 453(b)(2)(B).

27. Treas. Reg. § 1.453-4(c) (1958). Thus, if the taxpayer sold realty with an adjusted basis of $50 for $100, and the property were subject to a mortgage of $70, the taxpayer could only receive $10 in the year of sale. The mortgage relief exceeds the taxpayer's basis by $20, and that debt relief plus the $10 received would equal 30% of the $100 selling price.

28. I.R.C. § 453(b)(2)(B). It is clear, however, that the "evidence of indebtedness" exclusion does have its limitations. Any evidence of indebtedness will be counted as PYOS if payment is actually or constructively received in the year of sale or if payable on demand. I.R.C. § 453(b)(3). Also, a third party's note which the purchaser guarantees does not fit within the exclusion. Tombari v. Commissioner, 299 F.2d 889 (9th Cir. 1962). Further, evidence of indebtedness which is readily tradeable, such as a bond, is considered a PYOS. I.R.C. § 453(b)(3).

29. Gross profit is the taxpayer's realized gain on the sale, or the amount realized (selling price) *minus* the adjusted basis. I.R.C. § 1001(a). Total contract price is generally defined in Treas. Reg. § 1.453-4(c) (1958). To compute the total contract price, use the following formula: Selling price *minus* debt relief *plus* excess of debt relief over adjusted basis.

In situations where debt relief does not exceed adjusted basis, the total contract price simply equals the amount the taxpayer will actually receive from the purchaser (the net proceeds of the sale). If the debt relief equals or exceeds the adjusted basis, the profit reporting percentage will always equal 100%. Thus, if the taxpayer sells realty for $100 subject to a mortgage of $70 and has an adjusted basis in the property of $50, the taxpayer will have: (1) A gross profit of $50 ($100 (selling price) *minus* $50 (adjusted basis)); and (2) a total contract price of $50 ($100 (selling price) *minus* $70 (debt relief) *plus* $20 (excess of debt relief over basis)). The profit reporting percentage (gross profit/total contract price) will equal 100%, and, thus, the entire amount of the installment payments received by the taxpayer will be reported as taxable gain.

III. Combining Sections 1031 and 453

The foregoing discussion dealt with two widely used but distinctly separate planning tools. Whereas section 1031 defers recognition of gain until a subsequent taxable transaction, section 453 deferral spreads recognition of gain over the term the note payments are received.[30] Section 1031 applies automatically to deny recognition of gain or loss, while the taxpayer must specifically elect the benefits of section 453.[31]

There is an analogous dilemma facing: (a) a taxpayer who makes a sale of property on an installment method and receives notes but not enough cash to satisfy the consequent tax liability; and (b) a taxpayer who effectuates a partially "tax-free" exchange of properties, receiving boot in the form of notes, but receives insufficient cash to satisfy the resulting tax liability. The latter situation calls for benefits similar to those afforded the former situation. This situation led to the hybrid 1031/453 exchange[32] which allows nonrecognition treatment for the like-kind property received coupled with installment reporting for the boot received.

A. *Revenue Ruling 65-155*

Although scant attention has been focused upon the viability of the hybrid 1031/453 exchange, the Service expressly recognized its viability in Revenue Ruling 65-155.[33] This ruling introduces an important variation into the formula for calculating the profit reporting percentage. Whereas under conventional section 453 reporting, the percentage is determined by the proportion the gross profit bears to the total contract price, the percentage introduced by the ruling is the relationship that the total *recognized* gain from the section 1031 boot provision bears to the total contract price.[34] The ruling's example is illustrative of this change. Taxpayer X exchanged property with an FMV of $100 and a basis of $10 for Y's like-kind property worth $20, plus cash of $10, and notes of $70. Taxpayer X received the like-kind property and the $10 cash in the year of the exchange. X's total realized gain is $90 (FMV ($100) - Adjusted basis ($10)), but under section 1031, X is required only to recognize gain to the extent of the $80 boot received (Cash ($10) + Note ($70)).

The ruling further provides that the $20 like-kind property and the $10 cash received in the year of the exchange constitute PYOS. Thus, since the payments do not exceed thirty percent of the $100 selling price, installment reporting is available.

Conventional section 453 reporting yields a profit reporting percentage of 9/10 (ninety percent), representing the ratio X's gross profit ($90) bears to the contract price ($100). The ruling's modification, however, substitutes

30. *See* text accompanying notes 17-29 *supra*.

31. I.R.C. § 453(b)(1); Treas. Reg. § 1.453-8(b) (1958).

32. The phrase "hybrid 1031/453 exchange" is used to describe a transaction involving a § 1031 exchange in which the gain recognized under § 1031(b) is reported in accordance with § 453 installment sales requirements.

33. Rev. Rul. 65-155, 1965-1 C.B. 356.

34. *Id.* at 357.

"total gain recognized" for "gross profit" in the formula, resulting in a profit reporting percentage of 8/10 (eighty percent). Since this profit reporting percentage is applied against payments received in the year of exchange and against all payments received on the installment notes in subsequent years, all of the gain will eventually be reported. The recognized gain in the year of exchange is $24 ($30 x 80%), and, over the term of the notes, an additional $56 ($70 x 80%) is recognized yielding a total recognized gain of $80.

Unfortunately, Revenue Ruling 65-155 is incomplete because it fails to discuss the impact that a receipt of mortgaged property has upon the election of boot reporting under section 453. The ruling indicates that the "value" of the like-kind property received must be considered a PYOS,[35] but the definition of "value" is unclear. The ruling's example dealt only with nonmortgaged property, so the FMV controlled. If mortgaged property is received, the result under this ruling is still unresolved.

B. Clinton H. Mitchell

The case of *Clinton H. Mitchell*[36] provides insight into the property treatment of a 1031/453 hybrid transaction when mortgaged, like-kind property is received in the exchange. In *Mitchell*, the taxpayer exchanged two parcels of improved real property for a motel. The exchange agreement set a value of $148,000 for the taxpayer's properties (subject to an encumbrance of $18,502.39) and a value of $247,000 for the motel (subject to a deed of trust of $80,873.61). Of the $247,000 value assigned to the motel, $47,000 was allocated to tangible personal property used in the motel's operation.

Pursuant to the exchange agreement, the taxpayer/exchangor transferred two properties (subject to the encumbrance of $18,502.39) plus a note for $106,127.40 to the owner/exchangee of the motel. In return, the owner/exchangee transferred the motel (subject to the deed of trust of $80,873.61) and a secured note for $69,497.61 to the taxpayer.

In his original return for the year of the exchange, the taxpayer/exchangor stated that his realized gain was the face value of the note received from the owner/exchangee, but that his recognizable gain was limited to the actual payments received on the note. In subsequent returns, the taxpayer reported no further gains based on the contention that none were reportable until he had recouped his capital investment. The Commissioner challenged this method of reporting, ruling that the taxpayer must recognize gain in the year of exchange equal to the face value of the note received from the owner/exchangee.[37]

The taxpayer brought suit in the Tax Court, and prior to trial both parties stipulated that the note received was indeed section 1031(b) boot and that its face value, $69,497.61, constituted recognized gain. The dispute then focused upon the taxpayer's assertion that he should be allowed to re-

35. "The value of the like kind property received on the exchange must be treated as a part of the initial payment for the purpose of determining whether payments in the year of the sale or other disposition exceed thirty percent of the selling price." *Id.*

36. Mitchell v. Commissioner, 42 T.C. 953 (1964).

37. *Id.* at 958.

port this recognized gain under the installment provisions of section 453. The taxpayer's calculations for section 453 installment reporting paralleled those which would have been made if he had effected a straight sale of his two properties for cash and notes. Consequently, he looked to the value of his *own* properties in determining his selling price (although he improperly subtracted the amount of his mortgage) and ignored the value of the property he received. The taxpayer argued that under the thirty percent test, PYOS should include only $6,950—the amount received in principal and interest on the owner/exchangee's note in the year of the exchange. He further argued that the selling price *equalled his equity* in the two properties ($129,498), and, therefore, the thirty percent test was obviously satisfied since payments received on the note amounted to approximately five percent of the selling price. The calculations would have been proper (with the exception of the selling price[38]) if it had been a straight sale. The court, however, ruled that he incorrectly ignored both the value of the motel and the notes received in calculating both PYOS and the selling price.[39]

The significance of *Mitchell* rests in the court's analysis of section 453 and section 1031 requirements and their application in the context of an exchange which includes section 1031 boot. The court found that the taxpayer's selling price could not be determined solely by reference to the value of the properties he exchanged.[40] Instead the selling price included:[41]

The value of the motel	$247,000.00
Less the encumbrance on the motel	− $80,873.61
Plus the mortgage relief to the taxpayer	+ $18,502.39
Plus the face value of the note received	+ $69,497.61
Selling Price	$254,126.39

To qualify the boot for section 453 installment reporting, PYOS could not exceed $76,237.92 which is thirty percent of the $254,126.39 selling price.

The court also found that PYOS under the thirty percent test does not include evidence of the purchaser's indebtedness.[42] Thus, while the note constituted section 1031(b) boot, it was not included as a PYOS. Any payments made on the note in that year, plus any other payments in cash or property should have been included.[43] The court's holding reflects traditional application of both section 453 and section 1031 provisions.[44]

The court also held that the motel received in the exchange must be counted as a PYOS. Herein lies the court's insight into what constituted the "value" of the motel. While Revenue Ruling 65-155 indicates that "value" means FMV,[45] the *Mitchell* court held that the *equity* value (FMV less en-

38. Treas. Reg. § 1.453-4(c) (1958) provides that: "In the sale of mortgaged property the amount of the mortgage . . . shall, for the purpose of determining whether a sale is on the installment plan, be included as a part of the 'selling price'. . . ."

39. 42 T.C. at 965.

40. *Id.*

41. *Id.*

42. *Id.*

43. *Id.*

44. I.R.C. §§ 453(b)(3), 1031(b).

45. Rev. Rul. 65-155, 1965-1 C.B. 356, 357. The example given in the ruling uses the value of "worth" of the like-kind property as the amount which must be included in the PYOS.

cumbrances) and not the FMV represented the additional amount to be included as a PYOS. Thus, the total payments received by the taxpayer in the year of the exchange included:

Value of the motel	$247,000.00
Less the encumbrance on the motel	– $80,873.61
Plus payments on the principal received on the exchangee's notes in Year One	+ $3,554.39
Total payments received by the taxpayer in the year of exchange	$169,680.78

Although the taxpayer failed the thirty percent test, the significance of *Mitchell* lies in the court's conclusion that mortgaged property received in an exchange should be valued at its equity value when applying the thirty percent PYOS test of section 453.[46] Obviously, valuing mortgaged property received by the taxpayer at its equity value under the thirty percent PYOS test is logical. The irrationality of this position is illustrated by comparing the results of installment reporting when mortgaged property is valued at FMV rather than equity value. Assume the following facts: the taxpayer exchanges his property (FMV ($100); Adjusted basis ($50)) for other property, whether or not like-kind (FMV $20), assumes a mortgage of $10 on such property, and receives $90 of purchaser's notes which are payable over a six year period. Regardless of whether FMV or equity value is used, the thirty percent PYOS test is met, and the taxpayer may elect section 453 installment reporting.

The taxpayer's gross profit is $50 (FMV ($100)-Adjusted basis ($50)). Therefore, $50 is the numerator in the gross profit reporting percentage. The denominator is the total contract price, which is generally the amount of money or other property that the taxpayer receives in the sale of his property.[47]

If the mortgaged property is valued at FMV, the total contract price is $110 (FMV of property received ($20) + FMV of notes assumed to equal face value ($90)). Therefore, the gross profit percentage of $50/$110 yields a total recognizable gain of $50 when applied to the $20 of property received in the year of sale and the $90 of payments received on the notes.

This method of valuing mortgaged property causes the total contract price ($110) to exceed the selling price ($100). Since the section 453 regulations contemplate a total contract price equal to or less than the selling price,[48] this result is obviously an anomaly. Furthermore, the selling price

46. 42 T.C. at 965. "The 'selling price' . . . [included] the *net value* of the motel and furnishings . . . ." Net value and equity value are functional equivalents.

47. Thus, any liabilities of the taxpayer assumed by the exchange partner would not be included in the total contract price, unless the amount of liabilities assumed exceeds the taxpayer's adjusted basis in the exchanged property in which case that excess is included as a PYOS. Treas. Reg. § 1.453-4(c) (1958). *See also* note 36 *supra*.

48. Treas. Reg. § 1.453-4(c) (1958) provides that any mortgage of the taxpayer assumed by the purchaser is to be excluded from the total contract price except to the extent the mortgage exceeds the taxpayer's adjusted basis in the property. Under Crane v. Commissioner, 331 U.S. 1 (1947), such excess mortgage relief is included in the amount realized which usually equals the selling price.

represents the total value the taxpayer realizes on a sale or exchange of property, and it is inequitable to tax him on an amount in excess of the amount that he actually receives.

If the mortgaged property is valued at equity value rather than FMV, then the total contract price equals $100 (Equity value of property received ($10) + FMV of notes assumed to equal face value ($90)). In this situation, the gross profit reporting percentage of $50/$100 results in total gain recognition of $50 when applied to the $10 of property received in the year of sale and to the $90 of note payments received over the six year term of the notes. The total contract price equals the selling price which is the anticipated result when no liabilities are assumed.

Therefore, based upon *Mitchell*,[49] and the requirements of section 453 installment reporting, it is submitted that mortgaged property received by the taxpayer electing the installment method must be valued at its equity value—not its FMV.

IV. The Inconsistency Between Revenue Ruling 65-155 and Section 1031

A. *The Ruling's Approach*

Although in its modification of the section 453 profit reporting percentage, Revenue Ruling 65-155 gives lip service to the apparent purpose of section 1031,[50] the ruling nevertheless overlooks the basic premise underlying section 1031. If, under section 1031, no gain is to be recognized on the receipt of like-kind property, why does the ruling force recognition of gain in Year One on like-kind property merely because boot is received and installment reporting of the boot is desired?

This anomaly results from the ruling's adherence to an inflexible application of section 453.[51] With the ruling's modification of the profit reporting percentage, the entire gain to be recognized is not reached unless the reporting percentage is also applied to the like-kind property. This fact, however, defeats the purpose of section 1031 nonrecognition.

This inconsistency suggests that the flaw lies in the ruling's profit reporting percentage created by the ruling's failure to recognize the basic premise underlying section 1031.[52] The ruling's modified profit reporting percentage erroneously assumes that part of the like-kind property (twenty percent in the ruling's example) is not received in Year One, but instead is received as the notes are paid in the later years. The net effect of this erroneous assumption results in requiring gain recognition on like-kind property in Year One, with that forced recognition being returned in subsequent years through the

49. *See* note 46 *supra*.

50. "[T]he taxpayer should include in his gross income that portion of each payment received which the total gain to be recognized under section 1031(b) of the Code bears to the total contract price." Rev. Rul. 65-155, 1965-1 C.B. 356, 357.

51. *Id.* at 356-57. Section 453 requires reporting as income only that percentage of payments received during the year which equals the ratio of total profit *realized* over the contract price.

52. *See* text accompanying notes 17-23 *supra*.

modified profit reporting percentage. In sum, the ruling states that the like-kind property will be taxed now, but the tax will be returned later by not fully taxing the boot.

B. *Suggested Alternative*

A better approach, which permits the continuing viability of section 1031 while still reaching the entire inherent gain, requires an adjustment to the profit reporting percentage as provided in Revenue Ruling 65-155. If a transaction similar to that found in the ruling's example is considered a partial exchange for like-kind property and a partial sale for nonlike-kind property, and if section 1031's nonrecognition objectives are to be met, then section 453 installment reporting of the gain logically coincides only with the receipt of the *non*like-kind property. Achieving this equitable result merely requires that the profit reporting percentage be derived from and applied solely to the nonlike-kind property.

While the ruling modified the numerator of the profit reporting percentage to reflect the impact of section 1031, the denominator was derived from conventional installment sale reporting.[53] Instead of using traditional "contract price" in the denominator, only the boot portion of the transaction should be used to reflect that portion of the property actually "sold." The portion "exchanged" for like-kind property under section 1031 should be omitted from the denominator. Using the ruling's example, although this adjustment increases the profit reporting percentage to one hundred percent, it still reaches the entire gain when only applied to the nonlike-kind property as it is received. Thus, in Year One, the taxpayer reports as gain one hundred percent of the nonlike-kind property ($10 cash) received. In Years Two through Seven, the taxpayer recognizes one hundred percent of the $70 notes, thus eventually recognizing the required $80 gain. Not only does this approach comport with the underlying rationale of nonrecognition exchanges, but also the tax liability upon the taxable portion of the transaction is more accurately matched to the period in which the money is actually received.

Because the ruling's approach actually distorts taxable income, it could have serious tax consequences for the taxpayer. In the ruling's example, the taxpayer is forced to recognize $24 of gain in Year One, yet he has received only $10 cash with which to meet the tax liability. A taxpayer would fare even worse if he received notes of $80 and $0 cash in Year One which is not an uncommon transaction. If the profit reporting percentage of one hundred percent, as computed by the suggested alternative, however, is applied only against the nonlike-kind property, the taxpayer recognizes a $10 gain in Year One while receiving $10 in cash with which to satisfy the tax liability. The same matching of income received with gain recognition occurs in subsequent years as the notes are paid. Alternatively, if in Year One the taxpayer receives the like-kind property, $0 in cash, and $80 in notes, he should not recognize gain that year, but would report as gain under the suggested alternative, one hundred percent of the amount realized from the notes as

53. I.R.C. § 453(a)(2).

they are received. Under either approach, the taxpayer recognizes the entire \$80 gain, but the suggested alternative parallels the purpose of section 1031's nonrecognition provisions and resolves the inconsistency created by the ruling's approach.

V. TAXPAYER'S NEW BASIS—"TO BE" OR NOT "TO BE"

Revenue Ruling 65-155 also addresses the substituted basis provision of section 1031. In the conventional section 1031 tax-free exchange, the taxpayer's basis in the newly acquired property is calculated in accordance with Treasury Regulation section 1.1031(d).[54] The ruling provides that in a hybrid 1031/453 exchange, the taxpayer's new basis will be:

Basis in the property exchanged	\$10
Less cash received	− \$10
Less cash to be received	− \$70
Plus gain recognized in Year One	+ \$24
Plus gain to be recognized in five years	+ \$56
Basis in the property received	\$10

If the taxpayer were to immediately sell the new property for its FMV of \$20, he would realize and recognize a gain of \$10. This gain of \$10, plus the earlier recognized gain of \$80 equals the \$90 gain he would have recognized had he sold his original property at its FMV (\$100 less \$10 basis).

This ruling, however, fails to confront another issue raised by Treasury Regulation section 1.1031(d) regarding the allocation of the basis between the like-kind and nonlike-kind properties received. Theoretically, notes represent nonlike-kind property and are so treated in determining the amount of boot received.[55] The question is then raised as to whether Revenue Ruling 65-155 assigns a \$0 basis to the notes received in a hybrid 1031/453 transaction.

An argument can be made for adopting this position. The premise upon which such an argument can be based is Treasury Regulation section 1.1031(d)-1(c) which provides that:

> the basis (adjusted to the date of the exchange) of the property transferred by the taxpayer, decreased by the amount of any money received and increased by the amount of gain recognized, must be allocated to and is the basis of the properties (*other than money*) received on the exchange.[56]

Revenue Ruling 65-155, as noted above,[57] modified the basis formula of section 1031(d) in a hybrid 1031/453 transaction by decreasing the taxpayer's adjusted basis in the transferred property by the amount of any cash received and *to be* received and increasing it by the amount of gain recognized and *to be* recognized. Based partially upon the rationale found in the quoted regulation that basis is not allocated to the cash received, and also by apply-

54. *See* note 3 *supra*.
55. I.R.C. § 1031(a) specifically excludes notes as representing like-kind property. Therefore, notes must be boot.
56. Treas. Reg. § 1.1031(d)-1(c) (1956) (emphasis added).
57. *See* text accompanying notes 33-35 *supra*.

ing the modified basis formula of Revenue Ruling 65-155, it can be asserted that basis should not be allocated to the cash to be received on the purchaser's notes. A logical extension of this reasoning is that the purchaser's notes should not receive any basis allocation.

A problem arises, however, when the above reasoning is applied to a 1031/453 transaction because the Revenue Ruling's modified profit reporting percentage in the ruling's example is only eighty percent. When this profit reporting percentage is applied to the note payments as they are received, as required by the Revenue Ruling,[58] the twenty percent of the payments which are not reported as gain are necessarily considered a return of basis. This dilemma is resolved by assuming that the basis of the purchaser's notes is to be determined independent of the basis adjustments made pursuant to Revenue Ruling 65-155. This proposition assumes that the Revenue Ruling is not applicable to and was not intended to be applicable to the basis determination of the notes received.

A. *Independent Determination of Notes' Basis*

Section 453(d)(2) should be consulted to independently determine the basis of the purchaser's notes. Section 453(d)(2) states that "[t]he basis of an installment obligation shall be the excess of the face value of the obligation over an amount equal to the income which would be returnable were the obligation satisfied in full." The amount of gain "returnable were the obligation satisfied in full" is derived by subtracting the amount of gain recognized in the year of sale from the total recognizable gain.[59] Both the gain returnable on the obligation and the gain returnable in the year of sale are functions of the profit reporting percentage under section 453(b). As the profit reporting percentage changes, so does the amount returnable as gain upon payment of the notes in the subsequent years. The basis of the purchaser's notes will also be affected by changes in the profit reporting percentage.

Applying the above formula to the ruling's example with an assumed profit reporting percentage of eighty percent, the notes would have a basis of twenty percent of their value or $14. If the notes were sold at their face value, the reportable gain would be $56 ($70 - $14). This amount, plus the recognized gain of $24 in Year One, would equal the total gain of $80 which should be recognized. Finally, if the newly acquired property with a basis of $10 is sold for its FMV of $20, this gain of $10 would account for the realized, but not recognized gain, arising from the transfer of the taxpayer's original property.

If the profit reporting percentage is one hundred percent, as proposed in the suggested alternative, and that percentage is applied only against the nonlike-kind property of cash and notes, the notes have a $0 basis. If the $70

58. Rev. Rul. 65-155, 1965-1 C.B. 356, 357. The example used in the ruling would cause the recognition of $8 of each $10 of gain realized upon the receipt of the annual installment payments. By necessity, this would result in $2 of the annual installment payments being classified as a return of basis.

59. I.R.C. § 453(d)(2); Treas. Reg. §§ 1.453-9(b) to 9(b) ex. 1, -9(c) (1958).

notes are immediately sold, then the entire $70 is gain. Since the $10 cash was recognized gain in Year One, the total gain recognized is the required $80. Again, the remaining $10 of gain realized, but not recognized at the time of the exchange, is recognized if the taxpayer sells the new property for its FMV ($20 - $10 basis). Thus, the total $90 realized gain must eventually be recognized.

B. *The Unified Approach*

The basis problem presented by Revenue Ruling 65-155 can be resolved by replacing the ruling's modified basis formula with the normal section 1031(d) approach, but instead of assigning the notes received an FMV basis, the notes should be assigned a section 453(d)(2) basis.

The normal section 1031(d) basis formula is: the basis of the new property equals the adjusted basis of the exchanged property minus the money received plus the gain recognized.[60] Using the eighty percent profit reporting percentage of Revenue Ruling 65-155 and applying the normal section 1031(d) formula, the aggregate basis to be allocated among the properties received by the taxpayer under the facts of the ruling equals $24 (Adjusted basis of exchanged property ($10) − Money received ($10) + Gain recognized ($24)).

This aggregate basis would first be allocated under section 453(d)(2) to the installment obligations[61] (which basis is $14 as determined above), leaving $10 of the aggregate basis to be allocated to the like-kind property received. This approach is logical since it leaves the taxpayer in the same position with respect to the basis of the like-kind property received as he would have been under the ruling's approach, with $10 of realized but unrecognized gain which will be taken into account upon an immediate sale of the like-kind property at its FMV of $20. Also, the total recognizable gain of $80 would be reportable over the term of the installment obligations. A gain of $24 is reported in the year of sale, and an additional gain of $56 is reported as the notes are paid (the profit reporting percentage remains unchanged).

The application of this "unified approach" in determining basis allocation in a hybrid 1031/453 transaction is equally valid if the profit reporting percentage of the suggested alternative[62] is utilized. Applying the suggested alternative to the facts of Revenue Ruling 65-155 results in $10 of cash being received, but only $10 of gain is recognized in the year of sale since the gross profit percentage is determined solely with reference to the amount of boot received and not with reference to the total contract price. Under the "unified approach," the aggregate basis allocated to the properties received is $10 (Adjusted basis of exchanged property ($10) − Money received ($10) + Gain recognized ($10)).

Under section 453(d)(2), the basis of the notes would first be determined

60. *See* note 3 *supra* for an expanded discussion of the § 1031(d) basis formula.
61. I.R.C. § 453(d)(2); Treas. Reg. §§ 1.453-9(b) to 9(b) ex. 1, -9(c) (1958).
62. *See* text accompanying note 53 *supra*.

and would be $0 given a gross profit percentage of one hundred percent. Because the aggregate basis of $10 is then assigned to the like-kind property received, the taxpayer is in the same position with respect to the basis of the like-kind property as he would be if the formula of Revenue Ruling 65-155 were applied. Since the profit reporting percentage remains at one hundred percent, the $80 of boot to be received will be entirely recognized as gain over the term of the notes.

It might be argued that utilizing the "unified approach" to determine basis in the hybrid 1031/453 transaction is invalid since an FMV basis is not allocated to the notes received as seemingly required by Treasury Regulation section 1.1031(d)-1(c).[63] In response to this challenge, it is suggested that the regulations do not contemplate section 453 installment reporting of gain recognized on boot received in a section 1031 exchange. For example, an FMV basis is not assigned to any evidence of indebtedness received when installment method reporting is elected under section 453(b) because the total recognizable gain is deferred over the term of the installment obligations.[64] If FMV is allocated to installment obligations, it is relatively simple to dispose of the notes immediately thereby causing no gain to be recognized upon the orginal dispostion when the notes were received. This potential abuse is prevented by the basis provisions of section 453(d)(2).[65] There is no legitimate reason for a different result simply because installment reporting of the boot received in a like-kind exchange is elected.

Since the "unified approach" is in harmony with the basis provisions of both section 453(d)(2) and section 1031(d), it is suggested that this approach should be used in determining basis in a hybrid 1031/453 transaction. Regardless of which approach is used to allocate basis to the notes, it is apparent that the notes must have a basis other than $0 whenever the profit reporting percentage is less than one hundred percent and that Revenue Ruling 65-155 is clearly incorrect if it is interpreted as holding that the notes received in a hybrid 1031/453 transaction can never have basis. Using the ruling's figures and accepting, for the sake of discussion, that the notes received cannot have a basis, the like-kind property received has a basis of $10, and the notes have a basis of $0. Assuming that the FMV of the notes equals their face value and that the taxpayer immediately sells the notes, he would recognize a gain of $70 resulting in total gain recognition of $94. This result, of course, is incorrect since only $90 of gain was realized in the transaction of which only $80 was recognizable due to section 1031 nonrecognition. Therefore, it is clear that the basis provisions of Revenue Ruling 65-155 must be revised to incorporate either of the suggested approaches discussed above.[66]

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63. Treas. Reg. § 1.1031(d)-1(c) (1956): "For the purpose of the allocation of the basis of the properties received, there must be assigned to such other property an amount equivalent to its fair market value at the date of the exchange."

64. I.R.C. § 453(b)(2)(B) expressly excludes any evidence of indebtedness when determining the 30% test for payments made in the year of sale since, by their very nature, payments are not received until a later date.

65. *See* note 59 *supra* and accompanying text.

66. *Id. See also* text accompanying notes 60-66 *supra*.

VI. Multi-Party Exchanges

Hybrid 1031/453 exchange treatment can also be utilized in multi-party exchanges. The following discussion examines two variations of the multi-party exchange and considers the hybrid exchange tax treatment from the standpoint of both the Revenue Ruling and the suggested alternative.

A. *The* Alderson *Exchange Hypothetical*[67]

In this type of three-party exchange, assume B wishes to purchase A's apartment building, which has an FMV of $100 and an adjusted basis of $20, but A is only willing to exchange his property for a smaller property. B locates a duplex owned by C, which has an FMV of $30 and which is acceptable to A, but C is only willing to sell to B on an installment basis. B purchases C's duplex, giving $9 cash and a note secured by the property for $21. B and A then exchange properties with A assuming the $21 mortgage and B giving his note for $91 to A. What are the tax consequences to each party?

C qualifies for conventional section 453 installment reporting. The $9 cash received equals thirty percent of the selling price of $30. C will recognize gain based on the applicable profit reporting percentage applied against the $9 cash in the year of sale and the subsequent installments as they are received.

Although B would not qualify for section 1031 nonrecognition treatment because he acquired C's duplex expressly for the purpose of effectuating the exchange, he still suffers no adverse tax consequences. B's basis in the duplex is $30 under general *Crane*[68] principles. Although B receives $121 in property from A, the note he gives to A plus his basis of $30 offsets the amount realized to produce a gain of $0.

A is the candidate for hybrid 1031/453 treatment. Under section 1031, A should recognize gain on the lesser amount of boot received or gain realize. Although A receives $90 of boot (B's note), A's realized gain is only $80 (Property received ($30) ÷ Note ($91) − Basis ($20) - A's assumed mortgage ($21)). A will eventually have to recognize gain of $80 and will want to report this gain on the installment method.

Following the *Mitchell*[69] pattern, A's selling price is $100, consisting of the net value of the property received ($9) plus B's note of $91. Assuming

67. Alderson v. Commissioner, 317 F.2d 790 (9th Cir. 1963). In *Alderson*, the taxpayers amended a sales contract regarding their property to provide for an exchange of properties with the purchaser rather than a straight sale. The taxpayers located the desired exchange property (then owned by an independent third party), negotiated the sale with the third party to the purchaser (even writing buyer's escrow instructions), and then exchanged their property for the purchaser's simultaneously acquired property. The court held that the transaction was a valid § 1031 exchange finding that the purchaser did not act as the taxpayers' agent and that even if he had done so, § 1031 nonrecognition treatment was not precluded. *See also* note 10 *supra*.

68. Crane v. Commissioner, 331 U.S. 1 (1947). Under *Crane* and Parker v. Delaney, 186 F.2d 455 (1st Cir. 1950), a taxpayer's cost basis in property includes the amount of a purchase money mortgage or the amount of an assumed mortgage which the purchaser takes subject to or acquires.

69. 42 T.C. at 965.

that there are no other PYOS, the net value of the property received ($9) is less than thirty percent of the $100 selling price. Thus, A can elect installment reporting.

1. The Ruling's Approach

A's profit reporting percentage under the ruling's approach is eighty percent which is derived by calculating the ratio that the total gain to be recognized (lesser of boot – $91 or gain realized – $80) bears to contract price ($100). Assuming no other PYOS, the profit reporting percentage is applied to the net value of the property received in the year of exchange ($9), and A recognizes a gain of $7.20 in Year One. As discussed previously,[70] however, this method forces recognition of gain on the like-kind property received—a result inconsistent with section 1031 principles of nonrecognition. As the $91 note is paid in subsequent years, eighty percent or $72.80 will be returnable as gain. Thus, the Service reaches the entire recognized gain of $80 ($7.20 + $72.80), but only at the expense of forcing recognition of gain on the like-kind property.

2. Suggested Alternative Approach

Again, modification of the reporting percentage would cure the above inconsistency. By substituting the $91 of boot for the contract price in the reporting percentage and applying that ratio ($80/$91) only against the nonlike-kind property, section 1031 objectives are met. Total gain eventually recognized is $80 (Notes ($91) × $80/$91), but this result is achieved without distorting section 1031 nonrecognition principles.

3. A's New Basis

It is assumed in determining A's new basis that an allocation of basis to the notes must be made and that the Revenue Ruling does not prohibit the assignment of basis to the notes. This allocated basis to the notes may be $0, if the profit reporting percentage equals one hundred percent, but the allocation process must still be considered.

Applying the basis formula from the Revenue Ruling and independently determining the basis of the notes under section 453(d)(2), A's basis in the newly acquired duplex is:

Old basis	$20
Plus gain recognized/Gain *to be* recognized	+ $80
Less cash received/Cash *to be* received	– $91
Plus mortgage assumed by A	+ $21
A's basis in newly acquired duplex	$30

A's basis in the purchaser's notes would vary depending upon whether the

70. *See* text accompanying notes 33-35 *supra*.

method and profit reporting percentage of the Revenue Ruling or of the suggested alternative was used.

Ruling's Approach	Alternative Approach
$\frac{\$80}{\$100} \times \$91$ Note = \$80 Gain	$\frac{\$80}{\$91} \times \$91$ Note = \$80 Gain
Therefore:	Therefore:
$\frac{\$20}{\$100} \times \$91$ Note = \$18.20 Basis	$\frac{\$11}{\$91} \times \$91$ Note = \$11 Basis

Applying the "unified approach" in determining basis, but otherwise following Revenue Ruling 65-155, the aggregate basis of the properties received is:

Adjusted basis of exchanged property	\$20.00
Less cash received	−\$ 0
Plus gain recognized	+\$ 7.20
Plus mortgage assumed[71]	+\$21.00
Aggregate basis of properties received	\$48.20

After first assigning the section 453(d)(2) basis to the notes, which is \$18.20 using the eighty percent profit reporting percentage of the ruling's approach, the remaining basis allocated to the duplex is \$30.

In contrast, application of the "unified approach" in determining basis and use of the suggested alternative yields an aggregate basis of the properties received of:

Adjusted basis of exchanged property	\$20
Less cash received	−\$ 0
Plus gain recognized	+\$ 0
Plus mortgage assumed	+\$21
Aggregate basis of properties received	\$41

As computed above, the section 453(d)(2) basis of the notes is \$11, leaving \$30 to be allocated to the basis of the duplex.

Assuming that the note was sold at its face value of \$91 and that the newly acquired property with a basis of \$30 was sold at its FMV of \$30, then the result under the ruling's approach and the alternative approach is:

	Ruling's Approach	Alternative Approach
Gain on note	\$90 − \$18.20 = \$72.80	\$91 − \$11 = \$80
Plus gain recognized in Year One	\$ 7.20	\$ 0
Plus gain on property if sold	\$30 − \$30 = \$ 0	\$30 − \$30 = \$ 0
Total gain ultimately recognized	\$80.00	\$80

71. When mortgaged property is exchanged under § 1031, the basis formula of § 1031(d) is modified to take into account mortgages assumed and property which is received or exchanged

B. *The* Baird Publishing Company *Exchange Hypothetical*[72]

This version of the multi-party exchange differs slightly from the *Alderson*[73] situation with respect to the roles assumed by the various parties. Although B's intent still is to acquire A's apartment building, B purchases it from C after A and C have exchanged properties. Assume that the same properties and values as discussed under the *Alderson* hypothetical above apply.[74] In a transaction, C and A exchange properties, C giving his property with an FMV of $30 and a note of $70 in return for A's apartment building. Then C transfers the apartment building to B in return for $9 cash and a secured note of $91 from B.

C cannot qualify for section 1031 treatment since the apartment building was acquired solely for immediate resale. Since C's role is that of "seller," his transfer of the apartment building to B in return for cash and notes will be a taxable event.[75] Depending on the numbers involved, C may qualify for section 453 reporting just as he did in the *Alderson* structure.

B, the "buyer," faces no tax consequences. He merely calculates his basis in the apartment building in accordance with *Crane* principles.

Again, A is the candidate for hybrid 453/1031 treatment. Applying the principles previously discussed,[76] the following columnar presentation will demonstrate the tax consequences to A and the calculation of his new basis:

		Ruling's Approach		Alternative Approach
(a)	Gain realized	Property received	$30	SAME
		Notes received	+$70	
		Basis	−$20	
			$80	
(b)	Boot received	Notes	$70	SAME
(c)	Gain recognized (lesser of a or b)		$70	SAME
(d)	Section 453 selling price	Property received	$30	SAME
		Notes	+$70	
			$100	
(e)	30% PYOS test	Satisfied: Property	$30	SAME

subject to a mortgage. The modified formula under § 1031(d) is: Adjusted basis of the exchanged property - Cash received - Taxpayer's liabilities assumed + Gain recognized + Exchange partner's liabilities assumed.

72. Baird Publishing Co. v. Commissioner, 39 T.C. 608 (1962). In *Baird*, the three party exchange essentially took the following form: the taxpayer wanted to exchange his property for another property he selected, which property was to be improved according to his specifications; the owner of the selected property (a real estate agent who agreed to improve the property) located a purchaser for the taxpayer's old property; the real estate agent sold the taxpayer's property to the purchaser. Viewing the real estate agent as an independent third party (as the court did), this transaction differs from the *Alderson* transaction in that the exchange is between the taxpayer and the third party, and the sale to the purchaser from the third party follows the exchange. The court found that the transaction was a valid like-kind exchange and that no disqualifying agency relationship existed between the taxpayer and the realtor.

73. 317 F.2d 790.

74. *See* text accompanying note 67 *supra*.

75. I.R.C. § 1001.

76. *See* notes 53-75 *supra* and accompanying text.

(f)	Profit reporting percentage	$\frac{\text{Gain recognized}}{\text{Contract price}} = \frac{\$70}{\$100}$		$\frac{\text{Gain recognized}}{\text{Boot}} = \frac{\$70}{\$70}$	
(g)	Gain recognized in Year One	$30 Like-kind property × 70% =	$21	$0; No nonlike-kind property received	
(h)	Gain recognized in later years	$70 Notes × 70% =	$49	$70 Notes × 100% =	$70
(i)	Total gain recognized (g+h)	$70 ($21 + $49)		$70 ($0 + $70)	
(j)	New basis:				

(1) Applying the basis formula of Revenue Ruling 65-155 to determine the basis of the duplex and independently determining the basis of the notes under section 453(d)(2):

(a) Duplex

Old basis	$20	Old basis	$20
Gain recognized/Gain *to be* recognized	+$70	Gain recognized/Gain *to be* recognized	+$70
Less cash received/ *to be* received	−$70	Less cash received/ *to be* received	−$70
	$20		$20

(b) Notes

70% of $70 = $49 Gain	100% of $70 = $70 Gain
30% of $70 = $21 Basis	0% of $70 = $0 Basis

(2) Applying the "unified approach" to determine basis:

Aggregate basis of properties received		Aggregate basis of properties received	
Old basis	$20	Old basis	$20
Gain recognized	+$21	Gain recognized	+$ 0
Less cash received	−$ 0	Less cash received	+$ 0
	$41		$20

Section 453(d)(2) basis of the notes equals $21, with $20 of the basis allocated to the duplex.

Section 453(d)(2) basis of the notes equals $0, with $20 of the basis allocated to the duplex.

		Ruling's Approach	Alternative Approach
(k)	Gain recognized if new property (FMV $30) is sold	$30 − $20 = $10	SAME
(l)	Ultimate gain realized and recognized (i+k)	$80 ($70 + $10)	SAME

If instead of being paid, the note were sold at face value, the following would result:

(m)	Basis and note	$21	$0
(n)	Gain on note if sold at face value	$49 ($70 − $21)	$70 ($70 − $0)
(o)	Gain recognized in Year One (g)	$21	$0
(p)	Total gain recognized (n + o)	$70 ($49 + $21)	$70 ($70 + $0)

(q)	Gain realized if new property (FMV $30) is sold (*see* k)	$10	SAME
(r)	Ultimate gain realized and recognized (p + q)	$80 ($70 + $10)	SAME

VII. Conclusion

As illustrated in the preceding hypotheticals, the "trade-down" exchange is best viewed as a partial exchange and a partial sale of property. The exchange aspect of the transaction results in the receipt of like-kind property entitled to section 1031 nonrecognition, while the sale results in the receipt of nonlike-kind property or boot which may be taxed upon receipt. This duality strongly militates against Revenue Ruling 65-155's interpretation and application of the profit reporting percentage. The ruling's approach, requiring gain recognition in the year of the exchange on the like-kind property received is inconsistent with the underlying intent of section 1031. It is logical to consider the like-kind property received as partial payment for the property transferred, and further, to include the net value of the property received in applying section 453's thirty percent PYOS test, but it does *not* follow that the like-kind payment received should be taxable. To so hold completely contravenes the purpose of section 1031.

The solution lies in the suggested alternative which places proper emphasis upon section 1031 objectives while still allowing the proper amount of gain to be recognized. Section 453 installment reporting purposes are likewise furthered in that reporting of gain is matched with the periodic receipt of payments.

Finally, the proper time and amount for reporting recognized gain in a hybrid transaction must logically be accompanied by a proper basis allocation for the properties received. The allocation of basis is not extensively analyzed in either Revenue Ruling 65-155, the *Mitchell* decision, or the Treasury Regulations. To avoid the untenable result of recognizing more gain than was realized, while allocating a transferred basis to the like-kind property, basis must also be allocated to the noncash nonlike-kind property whenever the profit reporting percentage is less than one hundred percent. Either the suggested alternative or the unified approach will accomplish this objective and accurately reflect the realities of this hybrid transaction.