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A Substance-Oriented Approach to the Boot-Netting Rules Under Section 1031 of the Internal Revenue Code: *Biggs v. Commissioner*

Since the enactment of section 1031 of the Internal Revenue Code,[1] courts have struggled to discover a principled rationale for applying it.[2] Contrary to the usual rule in tax law that substance prevails over form, the courts initially developed a theory of section 1031 in which form prevailed over substance.[3] This theory reached its height in *Alderson v. Commissioner*[4] and *Carlton v. United States*.[5] Recent decisions, however, have indicated a shift toward a substance-oriented analysis.[6] In *Biggs v.*

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1. The term "section 1031" refers not only to the current code but also to its predecessors, Revenue Act of 1924, ch. 234, § 203(b)(1), 43 Stat. 253; Revenue Act of 1928, ch. 852, § 112(b)(1), 45 Stat. 791; and Int. Rev. Code of 1939, ch. 1, § 112(b)(1), 53 Stat. 37. For the purposes of this Case Note, the relevant portions of section 1031 are:

§ 1031. Exchange of property held for productive use or investment.

(a) Nonrecognition of gain or loss from exchanges solely in kind.

No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidence of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

(b) Gain from exchanges not solely in kind.

If an exchange would be within the provisions of subsection (a), of section 1035(a), of section 1036(a), or of section 1037(a), if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions 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.

2. *See* Smith v. Commissioner, 537 F.2d 972 (8th Cir. 1976); Bell Lines, Inc. v. United States, 480 F.2d 710 (4th Cir. 1973); Crenshaw v. United States, 450 F.2d 472 (5th Cir. 1971), *cert. denied*, 408 U.S. 923 (1972); Carlton v. United States, 385 F.2d 238 (5th Cir. 1967); Alderson v. Commissioner, 317 F.2d 790 (9th Cir. 1963); Century Elec. Co. v. Commissioner, 192 F.2d 155 (8th Cir. 1951), *cert. denied*, 342 U.S. 954 (1952); 124 Front St., Inc. v. Commissioner, 65 T.C. 6 (1975); Coupe v. Commissioner, 52 T.C. 394 (1969).

3. Comment, *Section 1031 Exchanges: Step Transaction Analysis and the Need for Legislative Amendment*, 24 U.C.L.A. L. REV. 351, 363 (1976).

4. 317 F.2d 790 (9th Cir. 1963).

5. 385 F.2d 238 (5th Cir. 1967). For a discussion of this case, see notes 22 through 24 and accompanying text *infra*.

6. Rutland v. Commissioner, 36 T.C.M. (CCH) 40 (1977); Coupe v. Commissioner, 52 T.C. 394 (1969); Duhl, *Like-Kind Exchanges Under Section 1031: Multiparty Ex-*

Commissioner,[7] the Tax Court took a major step in that direction. The two principal issues in *Biggs* were whether a valid exchange under section 1031 had occurred and whether boot received in the form of cash can be netted with boot given in the form of debt assumption. The Tax Court decided affirmatively on both questions. In late 1980, the Fifth Circuit affirmed the Tax Court's decision.[8] The first issue is the main subject of both opinions. The second issue received only cursory treatment in the Tax Court opinion and is not mentioned in the Fifth Circuit opinion. Nonetheless, the second issue is perhaps the more important of the two and is the subject of this Case Note.[9]

I. INSTANT CASE

In 1968, Franklin Biggs owned two parcels of land in Maryland.[10] Hoping to dispose of the property in a partially tax-free exchange under section 1031, Biggs sought and found a purchaser, Shepard Powell, who was willing to help effect such an exchange.[11] Through a realtor, Biggs located four suitable exchange properties in Virginia. Biggs then arranged for Shore Title, Inc., (Shore) to buy the Virginia properties for $272,100[12] — Shore assuming an existing debt of $142,544.86 and Biggs essentially loaning Shore the balance due of $129,555.14.[13] On Febru-

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changes, Nonsimultaneous Exchanges and Exchanges of Partnership Interests, 58 TAXES 949, 954-957 (1980).

7. 69 T.C. 905 (1978), *aff'd*, 632 F.2d 1171 (5th Cir. 1980).

8. 632 F.2d 1171 (5th Cir. 1980).

9. Since the exchange issue and its components have already been treated elsewhere, this Case Note will focus on the boot-netting issue. *See* Duhl, *supra* note 6; Price, *Exchanging Like-Kind Property Under Section 1031*, 56 TAXES 594 (1978).

10. 632 F.2d at 1172.

11. *Id.* at 1172-73. Biggs originally listed his property for sale with a realtor, who introduced him to Powell. Biggs and Powell signed a memorandum of intent in which Biggs agreed to sell Powell the Maryland property for $100,000 cash and an $800,000 note. *Id.*

12. *Id.* at 1173. Shore Title, Inc., was a Maryland corporation owned and controlled by Biggs' attorney, W. Edgar Porter, and Porter's family. *Id.* This raises interesting agency questions which will not be pursued here. *See* 124 Front St., Inc. v. Commissioner, 65 T.C. 6 (1975); Coupe v. Commissioner, 52 T.C. 394 (1969); Price, *supra* note 9, at 598-99. Upon finding the property, Biggs executed a contract to buy the property in his own name, although this was later changed to list him as "agent for syndicate." Presumably the "syndicate" was to be Powell, but Powell was unwilling to actually take title. Therefore, Biggs assigned the contract to Shore and arranged for Shore to take title.

13. 632 F.2d at 1174. Upon signing the contract to buy the Virginia property, Biggs put down a deposit of $13,900. *Id.* at 1173. This has been added to the balance due at closing of $115,655.14 in order to simplify the facts because it is essentially an amount

ary 26, 1969, Powell signed a contract to buy the Virginia properties from Shore. Powell agreed to assume the $142,544.86 previously assumed by Shore as well as the debt Shore owed to Biggs, resulting in a total debt of $272,100.[14] The next day, Biggs and Powell executed a contract providing that Biggs would convey the Maryland property to Powell. In return, Powell would pay Biggs $100,000 in cash, issue him an $800,000 installment note, and assign Biggs his rights to purchase the Virginia property subject to the debts.[15] The fair market value of the Maryland property was $900,000, and that of the Virginia property, $272,100.[16]

Biggs contended that a valid tax-free exchange under section 1031 was accomplished. The Commissioner disagreed and assessed a deficiency. Because the basis of the Maryland property was $186,312.80, the Commissioner asserted that the entire realized gain of $718,687.29 should be recognized.[17] The Commissioner advanced three arguments in support of his position that the transaction was not a valid 1031 exchange. The Tax Court found all three arguments unpersuasive. First, the Commissioner insisted that for an exchange to take place, the two transfers must be contractually interdependent, meaning that neither party is obligated to transfer his property unless the other one also transfers his property.[18] Noting that Powell's contract to buy the Virginia property was assigned to Biggs as part of the consideration for the Maryland property, the court found that the transfers were part of an integrated plan to exchange property.[19] The court held that although the transfers were not contractually interdependent, the fact that they were part of an integrated plan was sufficient to qualify under section 1031.[20]

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owed by Shore to Biggs.

14. *Id.* at 1174. Powell also paid an additional $100 to Shore as consideration for the assignment of the contract to buy the Virginia property.

15. *Id.* at 1174-75. At the closing, Powell assigned his rights under the contract to Samuel and Maurice Lessans who in turn assigned their interest to a corporation, Ocean View. Ocean View, in turn, issued an $800,000 note directly to Biggs and other notes to the Lessans.

16. *Id.* at 1173; 69 T.C. at 908.

17. 69 T.C. at 912.

18. *Id.* at 914.

19. *Id.* at 914-15 (citing Bell Lines, Inc. v. United States, 480 F.2d 710, 713-14 (4th Cir. 1973)); *see* Crenshaw v. United States, 450 F.2d 472, 475-76 (5th Cir. 1971), *cert. denied*, 408 U.S. 923 (1972); Redwing Carriers, Inc. v. Tomlinson, 399 F.2d 652, 658 (5th Cir. 1968); Century Elec. Co. v. Commissioner, 192 F.2d 155, 159 (8th Cir. 1951).

20. 69 T.C. at 914-16.

Second, the Commissioner argued that Powell's failure to take title to the Virginia property prevented the finding of an exchange. The court held that Powell was not required to take title in order to effect a valid exchange.[21] Third, the Commissioner argued that the Tax Court was obliged to follow the Fifth Circuit decision in *Carlton v. United States*[22] and that the transaction should therefore be characterized as a sale rather than an exchange.[23] In *Carlton* the taxpayer exchanged his property for a contract to buy different property and cash equal to the fair market value of the property exchanged. The contract did not close until two days later, when the taxpayer paid the contract price and received a deed. The court distinguished *Carlton* on the basis that in substance, the taxpayer in *Carlton* sold his property, received the cash, and enjoyed unfettered use of the money until it was reinvested two days later.[24]

Based on the foregoing, the Tax Court ruled that the transaction qualified under section 1031 as a tax-free exchange on the ground that the substance of the transaction was that of an exchange and not that of a sale.[25]

It is not clear from the opinion whether Biggs or the Commissioner addressed the "boot-netting" issue of whether Biggs could net the amount of cash received, $900,000, with the amount of debts assumed, $272,100, in order to produce a figure of $627,900 of boot and hence recognized gain.[26] The court, however, implicitly resolved the issue. In addressing the boot issue, the court said:

> Although the petitioner received $900,000 when the exchange agreement was closed ($100,000 in cash and an $800,000 promissory note), $129,555.14 of such amount in fact represented repayment of loans previously made by the petitioner to Shore. . . . In addition, the Virginia property . . . was subject to mortgages in the total amount of $142,544.86, which the petitioner assumed; thus, part of the cash he received at the closing was to reimburse him for the assumption of such mort-

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21. *Id.* at 916-18.

22. 385 F.2d 238 (5th Cir. 1967).

23. *Id.* at 918-19. In Golsen v. Commissioner, 54 T.C. 742, 757 (1970), *aff'd on another issue*, 445 F.2d 985 (10th Cir.), *cert. denied*, 404 U.S. 940 (1971), the Tax Court announced the rule that it would follow the precedent of the circuit to which the case would be appealable, even if it considered the precedent wrong.

24. 69 T.C. at 918-19.

25. *Id.* at 912, 914, 918.

26. *See* Treas. Reg. § 1.1031(d)-2 (1960).

> gages. In substance, the petitioner exchanged his Maryland property for the Virginia property and $627,900 in cash or its equivalent.[27]

Thus, the court seems to have held that Biggs received boot of $627,900 and recognized gain in that amount.[28] The Commissioner appealed the decision to the Fifth Circuit.

The Fifth Circuit affirmed the decision of the Tax Court.[29] The proceeding focused on whether there had been a valid section 1031 exchange. The Commissioner relied heavily on *Carlton,* which the court distinguished on grounds identical to those cited by the Tax Court. The court also noted that in contrast to the situation in *Carlton,* Powell was personally obligated on the debts on the Virginia property and therefore had assumed the burdens of ownership.[30] Furthermore, the money Carlton received in the exchange was not earmarked for the purchase of the exchange property. Oddly, the Fifth Circuit and the parties apparently ignored the boot-netting issue; neither the court's opinion nor the Commissioner's brief discussed the problem. Appellee Biggs' brief simply relied on the Tax Court's finding of boot in the amount of $627,900.[31]

II. Analysis

By implicitly permitting Biggs to net debt assumed against cash received for purposes of computing boot, the Tax Court and the Fifth Circuit have invalidated one of the boot-netting

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27. 69 T.C. at 916-17 (citation omitted). The court appears to allude to the idea that the netting of the $129,555.14 can be rationalized on a different basis than the netting of the $142,544.86. The $129,555.14 is actually repayment of money previously put into the transaction. That this can properly be netted against the $900,000 was established in Commissioner v. North Shore Bus Co., 143 F.2d 114 (2d Cir. 1944). However, the facts still pose the question of whether debts assumed can be netted against cash received for purposes of computing boot. If only the $129,555.14 were netted against the $900,000, Biggs would have boot of $770,444.86. Since his realized gain was $718,687.29 and gain is recognized up to the amount of boot, his recognized gain under this theory would have been $718,687.29. Thus, it is clear that the court also allowed Biggs to net the $142,544.86 debt that he assumed against the cash and note he received for purposes of computing boot.

28. 69 T.C. at 916-17. Brief for the Appellee at 7, Biggs v. Commissioner, 632 F.2d 1171 (5th Cir. 1980).

29. 632 F.2d 1171 (5th Cir. 1980).

30. *Id.* at 1177.

31. Brief for the Appellee at 7, Biggs v. Commissioner, 632 F.2d 1171 (5th Cir. 1980).

rules in the regulations.[32] Nevertheless, this result is supported by the policy underlying section 1031.

The rules pertaining to boot and the netting of boot are contained in section 1031(b) and Treasury Regulations 1.1031(b)-1 and 1.1031(d)-2. When a taxpayer in a section 1031 exchange receives some non-like-kind property or cash (promissory notes are treated as cash[33]) in addition to the like-kind property, the fair market value of the non-like-kind property plus the amount of cash is called "boot."[34] Any gain realized must be recognized up to the amount of the boot.[35] When a taxpayer transfers property subject to a debt, the taxpayer is deemed to receive boot in the amount of the debt of which he is relieved.[36] If both properties are subject to debt, the taxpayer is permitted to net the amount of the debt of which he is relieved (boot received) with the amount of debt he assumes (boot given).[37] However, the regulations prohibit the taxpayer from netting boot received in the form of cash or other property with boot given in the form of debt assumption.[38]

In *Biggs*, the Maryland property was unencumbered and had a fair market value of $900,000. The Virginia property was subject to debt equal to its fair market value of $272,100. In return for the Maryland property, Biggs received $100,000 cash, an $800,000 note, and the Virginia property subject to the two debts. Under the boot-netting rules, Biggs could not net the cash and note he received with the debt he assumed.[39] Thus Biggs would receive boot of $900,000. The difference between the fair market value of the Maryland property, $900,000, and its basis, $186,312.80, would result in a realized gain of $713,687.20.[40] Be-

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32. It might be argued that the Tax Court did not intend to overrule the boot-netting regulation, but rather simply made a mistake. This seems very unlikely in view of the fact that the theoretical thrust of the opinion is to emphasize substance over form. As the analysis of this Case Note demonstrates, to uphold this regulation would violate the substance-over-form maxim. On the other hand, application of the maxim produces the result the court reached.

33. This follows from the fact that in a real estate exchange a note is not like-kind property and is therefore "other property or money." Treas. Reg. § 1.1031(b)-1, *as amended by*, T.D. 6935, 32 Fed. Reg. 15,822 (1967).

34. 69 T.C. at 912.

35. Treas. Reg. § 1.1031(b)-1, *as amended by*, T.D. 6935, 32 Fed. Reg. 15,822 (1967).

36. Treas. Reg. § 1.1031(b)-1(c), *as amended by*, T.D. 6935, 32 Fed. Reg. 15,822 (1967).

37. *Id.*

38. Treas. Reg. § 1.1031(d)-2, Example (2) (1960).

39. *Id.*

40. 69 T.C. at 912.

cause realized gain is recognized to the extent of boot, Biggs would recognize the entire gain, $713,687. However, the Tax Court seems to have held that he received boot of $627,900: the $900,000 cash and note less the $272,100 debt assumed.[41] Thus, without discussing the possible violation of the boot-netting rules, the court apparently allowed Biggs to net the cash and note received with the debts assumed.

Despite its violation of the regulation, the result in *Biggs* is sound because it is consistent with the policy underlying section 1031. The Tax Court discussed this policy in the following terms:

> The purpose of section 1031 . . . was to defer recognition of gain or loss on transactions in which, although in theory the taxpayer may have realized a gain or loss, his economic situation is in substance the same after, as it was before, the transaction. Stated otherwise, if the taxpayer's money continues to be invested in the same kind of property, gain or loss should not be recognized.[42]

In applying this policy to the facts in *Biggs*, both the Tax Court and the circuit court employed a substance-oriented analysis. The Tax Court explained how such analysis helps effectuate the purposes of section 1031:

> [U]ndue reliance on the form of these transactions frustrates the legislative purpose, that is, to defer recognition of gain or loss in instances in which the taxpayer continues his investment in property of a like kind. Undue reliance on form also produces capricious results; in cases which are not substantively different, courts are led to reach differing results. On the other hand, if we focus instead on the substance of the transactions, taking into consideration all steps which are part of an integrated plan, we reach results which are consonant with the legislative purpose and which treat all taxpayers even-handedly.[43]

In other words, the validity of regulations promulgated under section 1031 should be evaluated in terms of whether their application to transactions that are the same in substance but different in form results in identical tax treatment. The three examples set forth below collectively demonstrate that the

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41. *Id.* at 916-17.
42. *Id.* at 913 (citing H.R. REP. No. 704, 73d Cong., 2d Sess. (1934)).
43. *Id.* at 918.

regulation prohibiting the netting of cash boot received with debt-assumption boot given cannot withstand such substance-oriented scrutiny.

> *Exchange #1: A* owns unencumbered property *X* with a fair market value of $1,000,000 and a basis of $100,000. *B* owns property *Y* with a fair market value of $500,000, a basis of $100,000 and an encumbrance of $200,000. *B* also has $200,000 cash. Property *Y* has a net value of $300,000 ($500,000 fair market value less $200,000 debt). *A* and *B* want to exchange their properties under section 1031. Since the net value of property *X* is $1,000,000, *B* needs an additional $700,000 in order to complete the exchange. *B* gives *A* a note for $700,000 and the parties exchange the two properties. *A* has received property *Y* worth $500,000 and a note worth $700,000 and has assumed a debt of $200,000. Because under the current regulations the $200,000 debt cannot be netted against the $700,000 note, *A* has boot of $700,000. In contrast, *Biggs* permits *A* to net the debt against the note, resulting in boot and recognized gain of $500,000.
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> *Exchange #2:* Assume the parties begin in the same position as in exchange #1. *B* uses his $200,000 cash to pay off the loan on property *Y*. *A* and *B* exchange their properties and *B* gives *A* a note for $500,000. *A* has received property *Y* and a note worth $500,000; hence, he has boot and recognized gain of $500,000. Subsequent to the exchange, each party borrows $200,000 on his own property. In this example, both the regulation and *Biggs* produce the same result: *A* has boot and recognized gain of $500,000.
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> *Exchange #3:* Assume the parties begin in the same position as in exchange #1. *A* takes out a loan of $700,000 on property *X*, thereby reducing its net value to $300,000, the same as property *Y*. Thereafter, the parties exchange properties. *A* receives boot in the form of debt relief of $700,000 but he also gives boot by assuming a $200,000 debt. As in exchange #2, the application of *Biggs* and the regulations yield the same result: *A* has boot and recognized gain of $500,000.

The financial position of *A* at the end of exchange #1 is identical to his position at the end of exchanges #2 and #3. The same is true of *B*. *A* has property *Y* worth $500,000, subject to a debt of $200,000, and cash or a note of $700,000. *B* has property *X* worth $1,000,000, subject to a debt of $700,000, and $200,000 cash. In each case *A* realized a gain of $900,000 and *B* realized a gain of $400,000.

Under the *Biggs* analysis, *A* recognizes a gain of $500,000 in

each exchange. However, under the regulations, cash and notes received cannot be offset by debt assumed for purposes of computing boot.[44] This produces different tax results in the three transactions. In exchange #1, *A* has boot and recognized gain of $700,000, whereas in exchanges #2 and #3 he has boot and recognized gain of only $500,000. Because the current regulation exalts form over substance, it does not reflect good tax policy. Taxpayers receive different tax treatment solely because their respective transactions, while substantively identical, are cast in different form. *A*'s continued investment in real property is the same in exchanges #1, #2, and #3. However, because in exchange #1 *A* is not permitted to net the boot received with the boot given, the legislative purpose of section 1031 is frustrated.[45] Furthermore, differences in form that are unimportant for tax purposes may be significant for business purposes.[46] Therefore, when variations in form do not require different tax treatment to further tax policy, regulations should not discourage such variations.

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44. Treas. Reg. § 1.1031(d)-2 (1960).

45. The following table shows, for each textually illustrated exchange, *A*'s financial position at the end of the exchange, his realized gain, and his recognized gain under Biggs and the current regulations.

EXCHANGE	#1	#2	#3
Property	$500,000	$500,000	$500,000
Debt	200,000	200,000	200,000
Cash and/or Note	700,000	700,000	700,000
Realized Gain	900,000	900,000	900,000
Recognized Gain:			
Biggs	500,000	500,000	500,000
Regulations	700,000	500,000	500,000

46. For example, the loan on property *Y* may carry a lower interest rate or have other terms which are more favorable than those presently obtainable. In such a case, *A* would want to assume the loan, if possible, rather than have *B* pay it off, as in exchange #2. Furthermore, *B* may prefer to finance the difference in the property values through *A* instead of through an outside lending institution. This is because *A* may offer *B* a lower interest rate or other more favorable terms than would otherwise be obtainable. In some cases, loans from third parties may be unobtainable. Since *A* prefers exchange #1 to #2 and *B* prefers exchange #1 to #3, the parties' natural choice would be #1 were it not for its adverse tax consequences. Thus, none of the alternatives is entirely satisfactory. Under *Biggs*, the parties can now enjoy the benefits of exchange #1 without its tax problems.

III. Conclusion

The decision in *Biggs* continues the trend toward a substance-oriented analysis of section 1031 like-kind exchanges.[47] Under this analysis, exchanges which are the same in substance should receive the same tax treatment regardless of differences in form. Preventing taxpayers from netting boot received in the form of cash or other property with boot given in the form of debt assumption treats similarly situated taxpayers differently. This violates the substance-over-form maxim and frustrates the legislative purpose of section 1031. By striking down this restriction in the boot-netting rules, *Biggs* affords taxpayers greater flexibility in structuring a section 1031 exchange.

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47. Duhl, *supra* note 6, at 954-57.