Section 1031 Exchanges: The Need For Consumer Protection

BY
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Almost everyone in the real estate industry today has heard about "1031 exchanges". The volume of Internal Revenue Code ("I.R.C.")[1] § 1031 exchange transactions in 2005 has been estimated at over $200 billion. A whole industry has sprouted to encourage and to support § 1031 exchanges. Unfortunately, these transactions have become so commonplace in the twenty-first century that taxpayers are increasingly entering into and closing real estate exchange transactions with only sporadic or no involvement by an I.R.C. § 1031 tax advisor.

Of course, qualified tax advisors know that in an Internal Revenue Service ("IRS") tax audit, a taxpayer has the burden of proof to establish that, despite all good intentions, taxpayer has actually met all the requirements of I.R.C. §1031. Nonetheless, real estate professionals have been involved in enough § 1031 exchange transactions that they have developed a false sense of security and are very comfortable involving themselves with a taxpayer's exchange transaction without bothering to *identify the person taking responsibility for giving § 1031 tax advice to taxpayer throughout the exchange process.*

Hawaii provides a unique microcosm to study the historical development of the § 1031 exchange industry and to draw conclusions about the rest of the country because of the accelerated pace of development forced upon this tiny island state. The first developments of an "industry" around transactions designed to qualify for the benefits of I.R.C. § 1031 probably began with the passage of the Tax Reform Act of 1986 (where sweeping reforms effectively increased the maximum long term capital gains rate by 40% and eliminated many of the previous tax benefits available from real estate investments), coinciding with the commencement of the huge inflow of United States real estate investments by the Japanese—where an estimated 20% of these Japanese investments went into Hawaii, a state representing only 0.2% of the land mass of the United States.

The large taxes resulting from the disposition of Hawaii real estate from 1986 until the early 1990s, a period of time generally associated with an economic recession in the continental United States, propelled the § 1031 exchange industry in Hawaii ahead of the mainland.

What is troubling today is that the current practices in the real estate industry nationwide regarding § 1031 exchanges unnecessarily expose the general public and real estate professionals to liability. This article will first attempt to identify the nature of the problem facing the real estate industry by: (i) explaining the overwhelming popularity of the "four-party exchange" structure today (utilizing the services of a "facilitator" or "Qualified Intermediary"); (ii) describing two business models for providing facilitator services in four-party exchanges; (iii) describing two widespread misconceptions within the real estate industry today about completing § 1031 exchanges; and (iv) showing that these two widespread misconceptions have resulted in the rise within the real estate industry nationwide of a faulty model for providing facilitator services to the general public.

After identifying the nature of the problem currently facing the real estate industry, this article will attempt to provide a solution based on simply educating the real estate industry on the importance of *identifying the person taking responsibility for giving § 1031 tax advice to taxpayers throughout the exchange process.* Finally, this article will show that the real estate industry's adoption of policy on the importance of *identifying the person taking responsibility for giving § 1031 tax advice to taxpayers throughout the exchange process* would naturally result in the implementation of consumer protection provisions already embodied in the existing ethical and professional rules applicable to any professional providing such I.R.C. § 1031 tax advice.

Historical Development In Structuring I.R.C. § 1031 Exchanges

The benefits of I.R.C. § 1031 go back to 1921 when the United States Congress enacted the precursor to I.R.C. § 1031(a)(1). Section 1031(a)(1) states the following: "[n]o gain or loss shall be recognized on the *exchange* of *property held for productive use in a trade or business or for investment* if such property is exchanged solely for property of *like kind* which is to be held either for productive use in a trade or business or for investment." [Emphasis added]. In 1921, Congress had in mind "two parties" swapping property.

Since it is very difficult to find two parties that own the exact properties that the other desires, it was not long before lawyers began re-structuring purchase-and-sale transactions to qualify by positioning the buyer to "swap" property with taxpayer as follows: buyer would use his cash to purchase the desired property from an unrelated third party-owner and then "swap" this newly acquired property with the taxpayer. The IRS was obviously displeased with such re-structuring, but it failed in its efforts to disallow properly documented transactions that came to be known as "three-party" exchanges (because they involved three separate parties instead of two).

These "three-party" exchanges have some obvious inherent limitations created by buyers' reluctance to get involved with the complexities of having to acquire yet another property for the sole purpose of "swapping" the replacement property with the taxpayer for the desired property. Therefore, these "three-party" exchanges are generally available only in a sellers' market where buyers are willing to accommodate sellers' requirements, but not in a buyers' market where sellers are unable to dictate a re-structuring of the normal purchase-and-sale transaction. Because of the difficulties inherent with consummating an exchange with someone who just wants to buy or sell real property, lawyers developed the "four-party" exchange to position the parties for a "swap" transaction.

In a "four-party" exchange, basically, a strawman, referred to as the "facilitator", "intermediary" or "qualified intermediary," is brought into the transaction for a fee to acquire the taxpayer's

property, sell the property to the interested buyer, use the proceeds from the sale to purchase the replacement property, and transfer the replacement property to taxpayer to complete the swap. The first court decision involving a "four-party" exchange was *Mercantile Trust Co. v. Commissioner*, 32 B.T.A. 82 (1935), where the court ruled favorably for the taxpayer because the facilitator, in this case, the title company, was not acting as the taxpayer's agent. This case illustrates not only the mechanics of effecting the necessary transfers, but also the importance of handling the various deeds and the purchase money in escrow carefully and correctly. By 1991, the IRS finally acknowledged the legitimacy of these "four-party" exchanges and issued regulations that gave taxpayers, among other things, a "safe harbor" roadmap to the proper structuring of exchanges through the use of a strawman that operated within reasonable limitations (defined in the 1991 regulations as a "Qualified Intermediary").

These 1991 taxpayer-friendly regulations simplified the structuring of § 1031 exchanges. The 1991 regulations eliminated tax advisors' structuring concerns over "agency" or "constructive receipt" issues and established the "four-party exchange" as the easiest and most dependable method for restructuring a purchase-and-sale transaction to convert it into an "exchange". Moreover, these regulations gave rise to a new industry for facilitator services independent of the tax lawyer structuring and implementing the § 1031 exchange that would function within the limitations imposed by the regulations so as to qualify as "Qualified Intermediaries".[2]

Two Business Models For Providing Facilitator Services

Conceptually, there are two business models available for offering facilitator services to the general public as follows:

The Full Service Model. The first model entails *combining* the "sell, buy & swap functions" of the facilitator with the *responsibility for giving the necessary § 1031 tax advice.*

Traditionally, lawyers that took responsibility for providing the necessary § 1031 tax advice to taxpayers would organize a separate corporate entity, which the lawyer controlled directly or indirectly, to act as the facilitator that would consummate the "sell, buy & swap function" to complete the taxpayer's exchange. Despite the fact that the facilitator was a separate entity from the lawyer, the facilitator was under the control of the lawyer, so the two functions were effectively combined. In fact, a taxpayer needed to deal only with the lawyer to complete the four-party exchange. However, there is no reason why a "full service model" could not be retained with an inverse relationship between a tax advisor and a facilitator where the facilitator entity hires the tax advisor and provides the public with the necessary § 1031 tax advice; provided, however, that the ethical and professional rules otherwise applicable to the hired tax advisor continues to apply for the protection of the public.

The Distributed Services Model. The second model entails *separating* the "sell, buy & swap functions" of the facilitator from the *responsibility for giving the necessary § 1031 tax advice.*

In Hawaii this second model probably began when the largest escrow company in the state, Title Guaranty Escrow Services, Inc., (Title Guaranty) responded to the increasing amount of § 1031 exchange transactions in 1987 by forming a wholly-owned subsidiary corporation, T. G. Exchange, Inc., to provide facilitator services.

Instead of supplying exchange agreements to its customers, T. G. Exchange, Inc. offered to work with any lawyer that accepted the responsibility for structuring these exchanges and drafting the appropriate exchange document; provided, however, that the exchange lawyer was willing to have his or her client, the Exchanger, sign the company's "Exchange Rider" containing provisions that it required for its protection in participating in these § 1031 exchanges. Almost all of the escrow companies in Hawaii immediately followed the lead of Title Guaranty and formed their own wholly-owned subsidiary corporations to offer facilitator services to the public. Not only did they adopt the second model, the Distributed Services Model, for providing facilitator services but they copied, word for word, the "Exchange Rider" of their competitor. Thus, the blossoming facilitator services industry in the State of Hawaii was clearly committed to this second model. By the end of the 1980s, Hawaii escrow companies had established the model in Hawaii whereby lawyers were taking responsibility for drafting the exchange documents and providing the necessary § 1031 advice, sometimes in conjunction with a C.P.A.[3] Hawaii lawyers were not motivated to organize a separate corporation to offer facilitator services to implement their own exchange transactions because of the convenience of the escrow company subsidiaries and the restrictions arising from the 1991 regulations defining the use of "Qualified Intermediaries" in structuring four-party exchanges.

Two Widespread Misconceptions In The Real Estate Industry Today

There are two widespread misconceptions in the real estate industry today about completing § 1031 exchanges, outlined below as follows:

A § 1031 Exchange Is An "Event". It is important to realize that a § 1031 exchange is not an "event", but a "process" that requires ONE person to: (i) take responsibility for the § 1031 tax advice; and (ii) oversee the whole "process". There is a pervasive misunderstanding in the real estate industry that a § 1031 exchange is an "event" similar to an escrow closing. This misunderstanding creates unnecessary problems. For example, it leads many people, including escrow officers, to simply order an "exchange agreement" at the eleventh hour, similar to ordering a conveyance document, as if the "exchange process" started and ended with the first leg of an escrow closing.

Prior to 1979, before the United States Court of Appeals for the Ninth Circuit decided *T. J. Starker v. Commissioner*, 602 F.2d 1341 (9th Cir. 1979), *aff'g and rev'g* 432 F. Supp. 864 (D. Or. 1977), a § 1031 exchange was basically an "event." Even four-party exchanges were structured to occur simultaneously so that an Exchanger received the Replacement Property at the same time that he or she disposed of the Relinquished Property. The *Starker* case marked the first time that a taxpayer's lawyer conceptualized the § 1031 exchange as a "process," rather than an "event," and the appellate court's decision legitimized this new concept of a § 1031 exchange as a "process."[4]

Starker's lawyer structured the exchange transaction so that the transfer of the Relinquished Property occurred in year 1 but the identification and subsequent receipt of multiple properties occurred over a two-year period. The whole exchange transaction covered three separate tax years. These exchanges became known as "Starker," "delayed" or "deferred" exchanges. Congress imposed limitations on this "process" in 1984 when it enacted § 1031(a)(3), requiring the identification of the Replacement Property within forty-five days and the receipt of the Replacement Property within the earlier of 180 days or the due date for filing

Exchanger's tax return for the year of the disposition.

Since a § 1031 exchange is clearly a "process," rather than an "event," it is imperative that taxpayer not commence the § 1031 exchange process unless taxpayer has identified one person to: (i) take responsibility for the § 1031 tax advice; and (ii) oversee the whole "process".

Qualified Intermediaries Take Responsibility For Giving Tax Advice Through The Whole Section 1031 Exchange Process. This second misconception is very widespread in the real estate industry today. Many real estate professionals believe *incorrectly* that facilitators or Qualified Intermediaries take responsibility for giving tax advice through the whole § 1031 exchange process. This is not generally the case because most facilitators today operate under the second model described above, separating the "sell, buy & swap functions" of the facilitator from the *responsibility for giving the necessary § 1031 tax advice.*

This second prevalent misconception probably results from the fact that most facilitators and Qualified Intermediaries today supply the taxpayer-Exchanger with an exchange agreement and other documents required to get the sales proceeds disbursed at closing to the facilitator (rather than the taxpayer-Exchanger). Despite the fact that these facilitator-provided exchange documents clearly urge the Exchanger-taxpayer to consult with its own lawyer and tax advisor because the facilitator is not taking any responsibility whatsoever for any tax advice, other professionals involved in the exchange transaction, i.e., the real estate broker, the escrow officer, and the lender, and the Exchanger, simply ignore such language and proceed under the mistaken assumption that the facilitator is in fact taking *responsibility for giving the § 1031 tax advice.*

Resulting Faulty Model For Providing Facilitator Services

The two widespread misconceptions in the real estate industry today have resulted in a serious flaw in the manner in which § 1031 exchange transactions are typically handled within the real estate industry. Outside of the larger commercial real estate transactions that typically involve lawyers negotiating and drafting the purchase-and-sale contract, the typical real estate purchase-and-sale transaction is negotiated by a real estate broker through the use of a standardized real estate "form contract" prepared by the local real estate association. The consumer's motivation to save on transaction expenses connected with the conversion of the "purchase-and-sale" transaction into an "exchange" transaction coupled with the apparent § 1031 expertise of the facilitators providing exchange documents designed to ensure disbursement of the sales proceeds to the facilitator most probably accounts for the extremely high number of exchange transactions closing without any *person taking responsibility for giving § 1031 tax advice to taxpayer throughout the exchange process.*

The main problem with the typical exchange transaction today is that the consumer, *i.e.*, the taxpayer-Exchanger, is never made to understand that he needs someone to *take responsibility for giving him or her § 1031 tax advice throughout the exchange "process"* and that the Qualified Intermediary is *not* taking any responsibility for providing this necessary tax advice, despite any apparent or real tax knowledge or expertise of any given person within the facilitator's organization. This problem could be rectified if the facilitator service industry examines its current manner of providing services to ensure that each service provider adopts either one of the two models described above, i.e., the Full Service Model or the Distributed Services Model. As it stands, the large majority of facilitator service providers are operating with a *faulty model*, that is, in between the two choices, whereby the provider appears to the public as operating under the "Full Service Model" (*i.e., combining* the "sell, buy and swap functions" of the facilitator with the *responsibility for giving the necessary § 1031 tax advice*) while *in reality* operating under the "Distributed Services Model" (*i.e., separating* the "sell, buy and swap functions" of the facilitator from the *responsibility for giving the necessary § 1031 tax advice*) as clearly stated in the facilitator-provided exchange documents.

If it is true that most § 1031 exchange transactions today are proceeding without anyone *taking responsibility for giving § 1031 tax advice to taxpayer throughout the exchange process*, then it should be clear to anyone that stops to think about it that this is not a good situation for either the consuming public or the "exchange industry." The tax responsibility vacuum left wide open by current industry practices is resulting in increasing numbers of tax returns *inappropriately* claiming the benefits of § 1031, either inadvertently or intentionally. It is only a matter of time before the IRS will decide to add Form 8824, Like Kind Exchanges, to its list of tax forms that trigger an IRS review or audit of the tax return.[5] If and when the IRS starts auditing these § 1031 exchanges, there will be an increasing amount of disgruntled Exchangers.

Consequences Of Failed Section 1031 Exchanges

There are significant adverse consequences to a taxpayer in the event that the IRS disallows the benefits of § 1031. In an IRS tax audit, taxpayer will have the burden of proving to the IRS that he or she qualifies for the benefits of § 1031. Because of the large amount of taxes normally deferred by participating in these § 1031 exchange transactions, an IRS disallowance of the § 1031 benefits would most probably subject taxpayer not only to the unpaid tax, but also to the 20% penalty based on mere "substantial underpayment" of tax under I.R.C. § 6662.[6] Moreover, taxpayer would be subject to interest charges on both the tax and the 20% penalty. Finally, in the event that taxpayer may have actually abused the exchange process to claim the § 1031 benefit, taxpayer may be subject to a civil fraud penalty of 75% under I.R.C. § 6663 or even criminal penalties for making material false statements under I.R.C. § 7206(1) or for tax evasion under I.R.C. § 7201.

The result of any IRS disallowance of § 1031 benefits claimed by taxpayer-Exchanger would be a very disgruntled person who would be looking to recover his or her losses by filing a lawsuit against the different parties involved with taxpayer's disallowed exchange transaction. If Exchanger cannot clearly identify the person that took *responsibility for giving him or her § 1031 tax advice throughout the exchange process*, then the Exchanger is more likely to bring suit against everyone involved in the exchange transaction, despite the disclaimers that each such person may have provided Exchanger.[7]

Proposed Solution: Industry Organizations Promote The "1031-Process-Rule"

The adverse consequences from disallowed § 1031 benefits are quite significant. It is in the interest of everyone in the exchange industry to help ensure that current practices promote compliance with the requirements of § 1031 to avoid an IRS focus on the industry and an IRS decision to target Form 8824 (Like Kind Exchanges) for tax review or audit because of perceived deficiencies in the exchange industry. Furthermore, if Congress perceives that the deficiencies in the exchange industry give rise to widespread taxpayer abuses, whether intentional or inadvertent, the whole exchange industry could be jeopardized because of the

possible repeal of § 1031.[8] Obviously, the best way to promote taxpayer compliance with the requirements of § 1031 is not simply to disavow responsibility, but to place importance in *identifying the person taking responsibility for giving § 1031 tax advice to taxpayer throughout the exchange process.*

The solution to this industry-wide problem is to have the various real estate organizations adopt and promote a simple rule designed to promote tax compliance with respect to its members' involvement in § 1031 exchanges as follows: ***"In any specific exchange transaction there should always be someone raising his or her hand to acknowledge responsibility for the I.R.C. § 1031 tax advice to taxpayer throughout the whole exchange process."*** (the "*1031-Process-Rule*"). Below is a real life example of what could happen if the 1031-Process-Rule is disregarded.

In 2003, a husband and wife owned investment property in California. They listed their property with a real estate broker to market the property and obtain the highest price possible. They hired and relied upon a national exchange company, *i.e.*, a Qualified Intermediary, in California to provide the documents necessary to complete a § 1031 exchange and the first leg escrow closed in California without a hitch. The couple hired a reputable law firm in Hawaii to organize an LLC[9] because they had heard about the benefits of utilizing an LLC. They also intermittently sought the advice of their California CPA to ensure that they were proceeding properly. They hired a real estate broker in Hawaii to find the appropriate replacement property. Finally, they acquired the Hawaii replacement property through the LLC to complete the second leg of their 1031 exchange. Despite all the expertise provided by many competent professionals, the exchange failed to qualify for the benefits of § 1031 because the "1031-Process-Rule" was violated. There was no *one* person overseeing the "exchange process". But why did the exchange fail?

The requirements of § 1031 were not met because the LLC did not qualify as a "disregarded entity" for tax purposes and the replacement property was, therefore, deemed to be a "partnership interest" instead of "like-kind" real estate. Revenue Procedure 2002-69 would have saved the day for this couple but for the fact that the couple changed their residence from California, a community property state, to Hawaii, a non-community property state. If the last two sentences make absolutely no sense, don't worry unless you are in the business of providing § 1031 advice. The point is that the requirements of § 1031 remain complex and the different real estate professionals involved in an exchange transaction should adhere to the 1031-Process-Rule in participating in § 1031 exchanges.

Probable Industry Impact Of Promoting The "1031-Process-Rule"

Promotion of the 1031-Process-Rule would definitely increase compliance with the requirements of § 1031 because *the person taking responsibility for giving § 1031 tax advice to taxpayer throughout the exchange process* would be properly identified and relied upon by the taxpayer-Exchanger. The 1031-Process-Rule incorporates concepts contrary to the two widespread misconceptions described above, so promotion of the 1031-Process-Rule not only eliminates those misconceptions but it also automatically corrects the faulty model currently in use for providing facilitator services because it forces someone to take responsibility for assuring compliance with § 1031 either through the Full Service Model or the Distributed Services Model. Of course, promotion of the 1031-Process-Rule will result in an adjustment to the facilitator services industry. Facilitators adopting the Distributed Services Model will need to determine how they will "dance" with the *person taking responsibility for giving § 1031 tax advice to taxpayer throughout the exchange process.* These facilitators are accustomed to providing exchange documents that contain provisions designed to protect them from liability while the *persons taking responsibility for giving § 1031 tax advice to taxpayer throughout the exchange process* are probably organized for efficiency and utilizing their own exchange documents. The solution that will probably be worked out in the "marketplace" will be along the lines developed by T. G. Exchange, Inc. in Hawaii. T. G. Exchange, Inc. signs the exchange documents prepared by the § 1031 tax advisor, but it provides its own "Exchange Rider" designed to: (i) supersede any contrary provisions in the exchange documents; (ii) avoid interfering with the structure of the exchange transaction designed by the § 1031 tax advisor; but (iii) containing the protective provisions they require to induce their participation as facilitators in these § 1031 exchanges.

Promoting "1031-Process-Rule" Synonymous With Promoting Consumer Protection

Industry promotion of the 1031-Process-Rule will increase compliance with the requirements of § 1031 because *the person taking responsibility for giving § 1031 tax advice to taxpayer throughout the exchange process* will be properly identified and relied upon by the taxpayer-Exchanger. The sooner the various players in a real estate exchange transaction, *i.e.*, real estate broker, facilitator, escrow, lawyer, and lender, focus on identifying the § 1031 tax advisor rather than on disclaiming their own involvement as the tax advisor, the sooner the Exchanger can gain access to the consumer protection provisions that have been in place for many years in the tax industry.

Professional organizations that regulate tax practitioners have developed ethics and professional responsibility rules that establish the standard of care applicable to their members. These rules are designed to protect the public and maintain the integrity of the tax system. The American Bar Association has issued Opinion 85-352, which provides in general that a lawyer may advise reporting a position on the taxpayer's return so long as the position possesses "some realistic possibility of success if the matter is litigated."[10] The American Institute of Certified Public Accountants ("AICPA") has adopted a very similar standard in that a CPA should not recommend a return position unless the CPA has "a good faith belief that the position has a realistic possibility of being sustained administratively or judicially on its merits if challenged."[11] Finally, the IRS has also adopted a very similar standard in its regulations governing practice before the IRS, Treasury Circular 230,[12] providing that a tax practitioner may not sign a return as preparer if it contains a position that does not have a realistic possibility of being sustained on its merits unless the position is not frivolous and is adequately disclosed to the IRS. By identifying the § 1031 tax advisor in an exchange transaction, the Exchanger/consumer is provided some measure of protection by these professional responsibility rules because it allows the Exchanger to rely on the standard of care governing such tax advice.

This 1031-Process-Rule would increase compliance with the requirements of § 1031 because it would shift the current focus of the various real estate professionals away from simply providing disclaimers about their involvement to identifying the person taking responsibility for the § 1031 advice throughout the whole exchange process. The 1031-Process-Rule would also eliminate the faulty model for providing facilitator services and allow the Exchanger to access the consumer protection provisions currently

available through the standard of care imposed upon tax advisors by existing ethical and professional responsibility rules and Treasury Circular 230.

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[1] Internal Revenue Code of 1986, as amended.

[2] Treasury Regulations § 1.1031(k)-1 was first introduced in T.D. 8346, 56 FR 19938 (May 1, 1991). It provided, among other things, four different "safe harbor" roadmaps to structuring deferred or Starker exchanges in Treas. Reg. § 1.1031(k)-1(g). Under these regulations, one way of resolving the "constructive receipt" and "agency" concerns for structuring a four-party exchange was to utilize a strawman or facilitator that met the requirements of a "Qualified Intermediary", defined in Treas. Reg. § 1.1031(k)-1(g)(4)(iii) to exclude the taxpayer or a "disqualified person", which in turn was defined in Treas. Reg. § 1.1031(k)-1(k) to include an unrelated party that has "acted as taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within... 2 year period..., [excluding I.R.C. § 1031 exchange related services to taxpayer]." The author believes that this taxpayer-friendly 1991 regulations gave rise to a new industry for "Qualified Intermediary" services because Treas. Reg. § 1.1031(k)-1(k) clearly defined and legitimized the use of "Qualified Intermediaries" in structuring four-party exchanges and lawyers were effectively precluded by these regulations from utilizing their own exchange companies in the process of taking responsibility for I.R.C. § 1031 tax advice to *existing* clients.

[3] It should be noted, however, that the 1991 Treasury Regulations encouraged the large title companies and other large national corporations to create subsidiary corporations to provide "Qualified Intermediary" services under the "safe harbor" provisions of these regulations. These large corporations have established offices in the major United States cities, including Honolulu. This expansion of the facilitator industry from the mainland to Hawaii has changed the manner in which Hawaii facilitators offer services. By the mid-1990s, most Hawaii facilitators were copying their mainland competitors and providing the public with exchange documents while simultaneously disclaiming responsibility for any I.R.C. § 1031 advice. Therefore, most Hawaii facilitators have inadvertently abandoned the Distributed Services Model without adopting the Full Service Model and have joined the ranks of facilitators operating under the faulty business model. Nonetheless, the facilitator subsidiary corporation of the largest title company in Hawaii continues to operate under the Distributed Services Model and still refuses to provide the public with exchange documents to ensure that a potential Exchanger seeks out a person that will take responsibility for the I.R.C. § 1031 tax advice throughout the whole § 1031 exchange process.

[4] It is interesting to note that the case was brought before the Ninth Circuit Court because a United States District Court judge reversed himself over this issue. District Court Judge Solomon had allowed a nonsimultaneous exchange for Bruce Starker (*Bruce Starker v. United States*, District of Oregon, Civil No. 74-133, April 23, 1975) but then denied his father, T.J. Starker, the benefits of I.R.C. § 1031 over the same contract in the subsequent case of *T.J. Starker v. United States*, 432 F. Supp. 864 (D. Or. 1977), by simply reversing his previous opinion. District Court Judge Solomon stated that "I have reconsidered my opinion in Starker I. I now conclude that I was mistaken in my holding as well in my earlier reading of *Alderson*." *Id.* at 868. The Ninth Circuit Court held that the doctrine of "collateral estoppel" prohibited District Court Judge Solomon from changing his mind about nine separate replacement properties acquired by T. J. Starker. However, the Ninth Circuit Court upheld the I.R.C.§ 1031 benefits for the tenth replacement property received by T. J. Starker and established the new view that a nonsimultaneous exchange qualified for the benefits of I.R.C.§ 1031. It is also interesting to note that the Court supported its holding by citing to an IRS victory in the Fifth Circuit case of *Redwing Carriers, Inc. v. Tomlinson*, 399 F. 2d. 652 (5th Cir. 1968), where the IRS had argued successfully to disallow taxpayer's loss because the mutual transfers of trucks that occurred "at or about" the same time were in fact an "exchange" under I.R.C. § 1031. The Ninth Circuit rejected the IRS' attempt to distinguish the cases based upon whether or not the period of time separating the disposition and acquisition was "substantial." Once the IRS successfully argued in the Fifth Circuit Court of Appeals that the mutual transfer of trucks occurring "at or about" the same time constituted a § 1031exchange, it opened the door to the view that a § 1031 exchange was a "process", and not an "event", like the recording of a conveyance document.

[5] Certain tax forms included with taxpayer's tax return, such as Form 8275 or Form 8275-R, trigger an IRS review of the return and significantly increase the probability of an IRS tax audit.

[6] The 20% penalty applies to any substantial underpayment of tax (generally defined as the greater of $5,000 or 10% of the correct tax), unless the taxpayer can show *either*: (i) the relevant facts affecting the treatment of the item on the return were appropriately *disclosed* in the tax return (normally using Form 8275 or Form 8275-R) *and* there is *reasonable basis* for his position; *or* (ii) taxpayer's position is supported by "substantial authority" (which is a higher standard than the "realistic possibility of success"). I.R.C. § 6662(d)(2)(B). However, no penalty shall be imposed on any portion of the underpayment of tax if taxpayer can show that: (i) there was *reasonable cause* for such portion of underpayment; and (ii) the taxpayer acted in good faith with respect to such portion. I.R.C. § 6664(c)(1).

[7] The first court case concerning the "related party" limitations of I.R.C. § 1031(f) involved a Hawaii exchange transaction, *Teruya Bros. Ltd. & Subsidiaries v. Commissioner*, 124 T.C. 45 (2005), in which the United States Tax Court upheld the disallowance of the I.R.C. § 1031 benefits taxpayer claimed and allowed IRS to assess a tax of $4.1 million plus interest. T.G. Exchange, Inc. was the facilitator involved in this four-party exchange transaction. It is interesting to note that the disgruntled Exchanger did not bother to take any action against *any* professional involved in the exchange transaction, except the I.R.C .§ 1031 tax advisor, because the facilitator's use of the Distributed Services Model for providing services forced the Exchanger to retain a lawyer to structure the exchange and draft the exchange agreement so that *the person taking responsibility for giving § 1031 tax advice to taxpayer throughout the exchange process* had been clearly identified by Exchanger. The disgruntled Exchanger retained a lawyer to pursue damages *only* against the person clearly identified as *taking responsibility for the § 1031 tax advice throughout the whole § 1031 exchange process.*

[8] The entire exchange industry should take notice of the precarious nature of its continued existence. Congressional perception about abuses in the exchange industry could result in the repeal of I.R.C .§ 1031 just as Congressional perception of abuses in the individual tax shelter industry of the 1980s resulted in its demise in 1986 through the passage of the passive loss rule of I.R.C. § 469.

[9] "LLC" means a limited liability company.

[10] *See* ABA Opinion 85-342, reprinted in 39 *Tax Lawyer* 237 (1976). *See also* ABA Website at *www.abanet.org* and click to Legal & Professional Resources, then Ethics Resources. This "realistic possibility of success" standard imposes a standard of care for lawyers giving § 1031 advice, such

(*Continued on page 113*)

In the current war against terrorism where unlikely scenarios at times seem to be coming true, one would expect that martial law would not be declared. However, in the unlikely event that martial law is ever declared in any area of the United States attacked by terrorists, such as a city subjected to a "dirty nuclear bomb" or a severe chemical or biological attack, *Duncan v. Kahanamoku* serves as a reminder that, even if martial law is declared, civilian courts must be reopened as soon as the threat subsides.

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[1] Lydia Kamekaha Liliuokalani, Hawaii's Story by Hawaii's Queen 387 (C.E. Tuttle Co. 1964); see also, Gavan Daws, Shoal of Time: A History of the Hawaiian Islands 264-280 (University of Hawaii Press 1968) and Albertine Loomis, For Whom Are the Stars? Revolution and Counterrevolution in Hawaii, 1893 - 1895 5-23 (University of Hawaii Press 1976).

[2] For details of events involving the *Massie* case, this author has relied upon the account in David E. Stannard, Honor Killing: How the Infamous "Massie" Affair Transformed Hawaii 43-64, 197-217, 247-258, 376-391 (Viking/Penguin Group 2005).

[3] There are no longer any courtrooms on the ground floor. The state supreme court is located on the second floor.

[4] *Id.* at 217.

[5] *Id.* at 245.

[6] *Id.* at 246.

[7] *Id.* at 389-390.

[8] Stannard at 396-399.

[9] Ann Rayson, Modern History of Hawaii 195 (Bess Press 2004).

[10] *Id.* at 197.

[11] 467 U.S. 229 (1984).

[12] 467 U.S. at 229.

[13] *Id.* at 236.

[14] *Id.* at 241-242.

[15] Ironically, Justice O'Connor found herself on the losing side in the case of *Kelo v. City of New London*, 545 U.S.___, 125 S.Ct. 2655, 162 L.Ed.2d 439 (2005) last year, in one of her last written opinions. The majority wrote that, under the precedent established in *Midkiff*, it was a legal public purpose for the City of New London to condemn the fee simple title to single family dwellers' homes and house lots along the New London riverfront, to pay them "fair compensation," and then to transfer fee simple title to Pfizer Drug Company, which planned an industrial development supposedly bringing more revenue to the city. In dissent, Justice O'Connor wrote that she viewed turning the fee simple title over to a private company was not within the meaning of a "public purpose." Meanwhile, the effect of the Land Reform Act is still a matter of hot debate. Some analysts assert the fact that Kamehameha Schools is worth more than six billion dollars today is that, instead of retaining the single-family dwelling lots from which the Schools were receiving only modest rents, sales of the fee simple interests gave the Schools substantial monies that the Schools invested in projects with much higher returns.

[16] 327 U.S. 304 (1946).

[17] *Id.* at 310-311.

[18] *Id.* at 324.

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(Continued from page 97, Nana I Ke Kumu)

for profit."

[4] 66 Haw. 1; 656 P.2d 745 (1982).

[5] For reasons not listed in the opinion, Kalipi did not assert rights based on easements or adverse possession.

[6] *Kalipi*, 66 Haw. at 15-16.

[7] 73 Haw. 578; 837 P.2d 1247 (1992).

[8] 79 Haw. 425; 903 P.2d 1246 (1995).

[9] 42 U.S.C. § 1996.

[10] 25 U.S.C. § 3001 et seq.

[11] *See* 25 U.S.C. § 3001(3)(D).

[12] For a detailed description of the dispute surrounding the *ki'i la'au*, see Isaac Moriwake, *Critical Excavations: Narrative, and the Debate on Native American and Hawaiian "Cultural Property" Repatriation*, 20 Haw. L. Rev. 261 (1998).

[13] The settlement involved a cash payment funding the museum's future Pacific collection, in exchange for allowing the Native Hawaiian organizations to take possession of the *ki'i la'au*, which was returned to Hawaii and treated in accordance with Native Hawaiian tradition.

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(Continued from page 121, 1031 Exchange)

as the following: (1) a lawyer is ethically permitted to advise the taxpayer to take a position on the return that subjects the taxpayer to the risk of the twenty percent "substantial underpayment" penalty because it is a lower standard than the "substantial authority" standard of I.R.C. § 6662(b)(2); (2) lawyers *must* inform the client of the penalty the client may suffer and the opportunity to avoid penalty by adequate disclosure of the return; and (3) if a lawyer determines that a position fails to meet the realistic possibility of success standard, the lawyer *must* counsel the client not to assert the position in the return without adequate disclosure.

[11] *See* Statement on Standards for Tax Services No. 1, "Tax Return Positions" at AICPA Website at *www.aicpa.org* and click to "Professional Ethics" to find the complete SSTS Nos. 1-8.

[12] *Practice Before the Internal Revenue Service*, 31 C.F.R. § 10.34 (2005).

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