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Cover Page Footnote

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COTTAGE SAVINGS ASSOCIATION v. COMMISSIONER: REFINING THE CONCEPT OF REALIZATION

LOREN D. PRESCOTT, Jr. *

Professor Prescott offers an indepth analysis of the Supreme Court's recent endorsement of the 'materially different' standard—the exchange of property for other property differing materially either in kind or in extent—as a measure for realizing income. After discussing the Court's endorsement, Professor Prescott discusses possible applications of the 'legal entitlements' test for evaluating 'material differences' to various property exchange transactions, and concludes that such application may alter the tax treatment of many traditionally tax-free transactions.

INTRODUCTION

THE idea that the concept of realization might be subject to doctrines limiting its application seems inconsistent with the scope of the sixteenth amendment ("incomes, from whatever source derived").[1] The United States Treasury Department, however, supports limiting realization in property exchanges to those transactions involving properties "differing materially either in kind or in extent."[2] Although Treasury has included this rule in its regulations since 1935,[3] few courts have relied on it to limit realization in property exchange cases.

Recently, the Supreme Court considered Treasury's "materially different" limitation on realization in *Cottage Savings Association v. Commissioner*,[4] a case involving the exchange of mortgage loans by savings institutions. The Court's endorsement of Treasury's "materially different" standard suggests that the concept of realization may not be as broad as once thought.

Part I of this article provides an overview of the concept of realization. Part II then examines the "materially different" standard by reviewing

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1. *See infra* note 11 for a brief summary of the sixteenth amendment.
2. Treas. Reg. § 1.1001-1(a) (as amended in 1972).
3. *See infra* notes 58-59 and accompanying text.
4. 111 S. Ct. 1503 (1991). The Supreme Court also considered this issue in a companion case, United States v. Centennial Sav. Bank FSB, 111 S. Ct. 1512 (1991). Because the Court based its decision in *Centennial* on the reasoning announced in *Cottage Savings*, this article focuses on the *Cottage Savings* decision.

the *Cottage Savings* decision, the Treasury Department's development of the standard, and the Supreme Court's other landmark realization decisions. Part III analyzes the Court's reasoning in *Cottage Savings,* discussing the justification for placing limits on realization, and Part IV then analyzes the Court's new "legal entitlements" test and suggests that use of this new standard to evaluate other types of transactions for "material differences" will produce unintended results.

I. THE REALIZATION REQUIREMENT

The Internal Revenue Code ("the Code") provides that gross income includes "[g]ains derived from dealings in property."[5] Although "dealings in property" is not defined within the Code, the word "dealings" suggests that some action must be taken with respect to property before the resulting gain constitutes income for purposes of federal income taxation.[6] Gain or loss is "realized" for tax purposes when, as a result of "dealings in property," the taxpayer's economic gain or loss is isolated from the underlying capital investment by some event.[7] Both the Code[8] and the Treasury Regulations[9] identify this event as a "sale or other disposition" or "sale or exchange."[10]

5. I.R.C. § 61(a)(3) (West Supp. 1986). Unless otherwise indicated, all references are to the Internal Revenue Code of 1986, as amended.

6. *See* 2 B. Bittker & L. Lokken, Federal Taxation of Income, Estates and Gifts 40.1, at 40-2 (2d ed. 1990); *cf. San Antonio Sav. Ass'n v. Commisioner,* 887 F.2d 577, 581-82 (5th Cir. 1989)("The Code does not define the term 'dealing' and it does not expressly state that gains and losses are disregarded until an act constituting 'dealing' in property takes place.").

7. *See* Eisner v. Macomber, 252 U.S. 189 (1920) (adoption of the concept of realization through severance of appreciation from capital). It should be noted that although the concept of realization adopted by the Court in *Macomber* is applied both to gains and losses, the decision in *Macomber* dealt only with gains and their inclusion in income under the Sixteenth Amendment. As there is no provision in the Constitution dealing with losses and their effect on income, the allowance of an income tax deduction for a realized loss is a matter of legislative grace. *See* 1 B. Bittker & L. Lokken, Federal Taxation of Income, Estates and Gifts 5.2, at 5-20, n.20 (2d ed. 1989).

8. Recently, the Supreme Court confirmed that the concept of realization is implicit in I.R.C. § 1001(a). *See Cottage Savings,* 111 S. Ct. at 1507; *see also* E. Colson, Federal Taxation of Sales, Exchanges and Other Transfers 4 (1971) (concluding that requirement of realization is implicit in the Code).

9. The first regulations promulgated under the Revenue Act of 1913 provided that gross income includes "appreciation in the value of assets, if taken up on the books of account as gain." Treas. Reg. No. 33, Pt. III, Art. 107 (1916). When these regulations were revised in 1918, however, this definition of income was modified: "gain realized . . . upon the sale of disposition of capital assets shall be returned as gross income." Treas. Reg. No. 33, Pt. II, Art. 106 (1918). This appears to be the first use of the term "realization" as a means of determining when a taxpayer has income within the meaning of the sixteenth amendment.

10. The phrases "sale or other disposition" and "sale or exchange" are used interchangeably in I.R.C. § 1001 (a),(c). *See* Helvering v. Roth, 115 F.2d 239, 241 (2d Cir. 1940); *see also* Del Cotto, *Sales and Other Dispositions of Property Under Section 1001: The Taxable Event, Amount Realized and Related Problems of Basis,* 26 Buffalo L. Rev. 219, 225-26 (1976) ("sale or other disposition" gains or losses are included in the recognition provisions for gains or losses from a "sale or exchange" of property). This triggering

The concept of realization was developed soon after the ratification of the sixteenth amendment[11] and the passage of the Tariff Act of 1913.[12] Confronted with constitutional and legislative language that failed to define the "income" on which a federal tax may be imposed, the courts were forced to establish a framework within which to define income.

The Supreme Court considered the meaning of income in a number of early cases[13], but its decision in *Eisner v. Macomber*[14] is recognized as the Court's first attempt to define the constitutional limits of income. In *Macomber*, the Court held unconstitutional a provision in the Revenue Act of 1916 that treated stock dividends as income.[15] Noting that the sixteenth amendment addresses "incomes, from whatever source derived," Justice Pitney wrote that income in the constitutional sense is a gain, a profit— "something of exchangeable value *proceeding from* the property, *severed from* the capital however invested or employed, and *coming in*, being 'derived,' that is, *received* or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal;—*that* is income derived from property. Nothing else answers the description."[16]

This requirement of "severance" from capital pronounced by the Court in *Macomber* evolved into the concept of realization; that is, ap-

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event, often referred to as a "taxable event" or a "realization event," is the subject of another definition:

> [t]he term "taxable event" is a convenient label for a transaction that meets all of the following conditions: (1) [i]t entails a disposition of property that is sufficiently definitive so that any appreciation or depreciation is properly viewed as realized; (2) the transaction is distinguishable from a gift, bequest, division of ownership, change of contract terms, or other event that alters the taxpayer's economic position but that for one or more of a variety of reasons does not give rise to current gain or loss; and (3) it entitles the taxpayer to offset the adjusted basis of the property against the amount realized therefor in determining whether the transaction produces gain or loss, and how much.

2 B. Bittker & L. Lokken, Federal Taxation of Income, Estates and Gifts 40.2, at 40-5 (2d ed. 1990).

11. The sixteenth amendment, ratified on February 3, 1913 and certified as part of the Constitution by the Secretary of State on February 25, 1913, provides: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

12. Pub. L. No. 63-16, 38 Stat. 114 (1913).

13. *See, e.g.*, Peabody v. Eisner, 247 U.S. 347, 348-49 (1918)(A dividend by a corporation of shares in another corporation is not a stock dividend and is taxable. Likewise, cash dividends distributed from current and prior earnings are taxable under the "surtax" provision.); Towne v. Eisner, 245 U.S. 418, 426-27 (1917)(value of new shares issued as a stock dividend is not "income" within the meaning of the Income Tax Law of 1913); Doyle v. Mitchell Bros., 247 U.S. 179, 185 (1918)(" 'Income may be defined as the gain derived from capital, from labor, or from both combined.' Understanding the term in this natural and obvious sense, it cannot be said that a conversion of capital assets invariably produces income."); Lynch v. Hornby, 247 U.S. 339, 344 (1918)(dividends from both current earnings and accumulated surplus are taxable as income under "surtax" provision).

14. 252 U.S. 189 (1920).

15. *See id.* at 219.

16. *Id.* at 207 (emphasis in original).

preciation in the value of an asset does not constitute income under the sixteenth amendment in the absence of an event that separates the appreciation from the related capital.[17] In an early tax statute, this "event" was described as a "sale or other disposition,"[18] and this continues to be the standard used to determine whether appreciation has been converted into income for federal income taxation purposes.[19] Although the importance of the "severance" requirement was questioned in a series of cases following *Macomber*,[20] the concept of realization remains a fixture of the

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17. It is well settled that the mere increase in value of property held does not make taxable income, but that it must be realized by some severance or change of investment. A money measured sale or an exchange for property having a readily ascertainable market value is the usual means of realization recognized by the statutes.

Bancker v.Commissioner, 76 F.2d 1, 2 (5th Cir.)(citations omitted), *cert. denied*, 296 U.S. 603 (1935). *See also* Cottage Sav. Ass'n v. Comm'r, 111 S. Ct. 1519, 1520 (1991) (Blackmun, J., dissenting)("It long has been established that gain or loss in the value of property is taken into account for income tax purposes only if and when [it] is 'realized,' that is, when it is tied to a realization event, such as the sale, exchange, or other disposition of the property. Mere variation in value—the routine ups and downs of the marketplace—do not in themselves have income tax consequences.").

18. This phrase was first used in § 202(a) of the Revenue Act of 1918, a provision that established guidelines for determining the basis of property. *See* Revenue Act of 1918, Pub. L. No. 65-254, § 202(a), 40 Stat. 1057, 1061 (1919). "Sale or other disposition" was first used in connection with the determination of gain or loss in the Revenue Act of 1924: "the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis provided in subdivision (a) or (b) of section 204, and the loss shall be the excess of such basis over the amount realized." Revenue Act of 1924, Pub. L. No. 68-176, § 202(a), 43 Stat. 253, 255 (1924); *see also supra* note 9 (discussion of Treasury's early interpretation of the term "gross income").

19. *But see, e.g.*, I.R.C. § 1256(a) (1991) (annual appreciation or depreciation in the value of unsold regulated futures contracts treated as income or loss for tax purposes). The regulations also provide that gain may be recognized, even in the absence of a sale or other disposition, "if the sum of all the amounts received which are required by section 1016 and other applicable provisions of subtitle A of the Code to be applied against the basis of the property exceeds such basis." Treas. Reg. § 1.1001-1(c) (as amended in 1972). This departure from the "sale or other disposition" benchmark does not apply to losses, however:

> [A] loss is not ordinarily sustained prior to the sale or other disposition of the property, for the reason that until such sale or other disposition occurs there remains the possibility that the taxpayer may recover or recoup the adjusted basis of the property. Until some identifiable event fixes the actual sustaining of a loss and the amount thereof, it is not taken into account.

Id.

20. Erosion of the concept of "severance" began with the Supreme Court's holding in United States v. Kirby Lumber Co., 284 U.S. 1 (1931), that a corporation realized income when it purchased its own bonds at a discount. In response to the taxpayer's argument that the gain inherent in the transaction was not yet severed from it's investment in the bonds, the Court said: "We see nothing to be gained by the discussion of judicial definitions. The defendant in error has realized within the year an accession to income, if we take words in their plain popular meaning, as they should be taken here." *Id.* at 3.

The trend continued with the Court's opinion in Helvering v. Bruun, 309 U.S. 461 (1940), a case that considered the question whether a landlord who repossessed property realized income to the extent the value of the property was enhanced by improvements made by the tenant. Noting that the "gain" was not yet severed from the landlord's investment, the Court held the "[i]t is not necessary to recognition of taxable gain that he

Federal Income Tax System.[21]

II. THE "MATERIALLY DIFFERENT" STANDARD

Section 1001(a) of the Internal Revenue Code provides for the computation of gain or loss on the sale or other disposition of property.[22] The Treasury Regulations promulgated pursuant to that provision state that "gain or loss realized from the conversion of property into cash, *or from the exchange of property for other property differing materially either in kind or in extent*, is treated as income or as loss sustained."[23] Although the decisions in a number of early property exchange cases were based on an application of this regulation,[24] there remained some question about the validity of such a limitation on realization until the Supreme Court's recent decision in *Cottage Savings*.[25]

A. *Cottage Savings*

Cottage Savings Association was a state-chartered mutual savings association. Like many other savings and loan institutions, Cottage Savings experienced financial trouble in the late seventies when a dramatic increase in interest rates forced it to pay more in interest to account and certificate holders than it earned on low-interest fixed term mortgage

should be able to sever the improvement begetting the gain from his original capital. If that were necessary, no income could arise from the exchange of property; whereas such gain has always been recognized as realized taxable gain." *Id.* at 469.

In 1940, the Supreme Court expanded the meaning of the term "income" in Commissioner v. Wilcox, 327 U.S. 404 (1946), when it held that "no single, conclusive criterion has yet been found to determine in all situations what is a sufficient gain to support the imposition of an income tax. No more can be said in general than that all relevant facts and circumstances must be considered." *Id.* at 407. The Court completed its expansion of the meaning of "income" in Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955), when it held that income includes any "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." *Id.* at 431.

21. *See* 1 B. Bittker & L. Lokken, Federal Taxation of Income, Estates and Gifts 5.2, at 5-17 (2d ed. 1989) ("realization is so basic to the structure of the law that the principle is not challenged").

22. Section 1001(a) provides as follows:

> The gain from the sale or other disposition of property shall be the excess of the amount realized over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

I.R.C. § 1001(a) (1991).

23. Treas. Reg. § 1.1001-1(a) (as amended in 1972) (emphasis added).

24. *See, e.g.*, Emery v. Commissioner, 166 F.2d 27, 29 (2d Cir. 1948) (predecessor to Treas. Reg. § 1.1001-1(a), Treas. Reg. § 29.111-1 imposed a "materially different" requirement on the exchange of bonds for bonds); Mutual Loan & Sav. Co. v. Commissioner, 184 F.2d 161, 165 (5th Cir. 1950) ("materially different" requirement used in bond for bond exchange transaction pursuant to Treas. Reg. § 29.111-1); City Bank Farmers Trust Co. v. Hoey, 52 F. Supp. 665, 666 (S.D.N.Y. 1942) (Treas. Reg. No. 86, Art. 111-1 imposed a "materially different" limitation on realization in bond for bond exchange).

25. Cottage Sav. Ass'n v. Commissioner, 90 T.C. 372, 374 (1988), *rev'd*, 890 F.2d 848 (6th Cir. 1989), *rev'd and remanded*, 111 S. Ct. 1503 (1991).

loans.[26] Although the resulting decline in the value of residential mortgage loans seemed to offer Cottage Savings an opportunity to recognize losses for tax purposes and thereby improve its cash position by claiming the resulting income tax refunds, applicable net worth requirements established by the Federal Home Loan Bank Board ("FHLBB") prevented the savings association from liquidating its mortgage loan investments.[27] The FHLBB, however, recognizing the restrictions placed on savings institutions by its net worth and reporting requirements, issued Memorandum R-49, a directive that relieved an institution of its obligation to report losses incurred by the sale of mortgage loans, provided that the institution satisfied the Memorandum's ten requirements.[28]

Relying on the guidelines set forth in Memorandum R-49, Cottage Savings engaged in a series of transactions in 1980, selling 90% participation interests in 252 mortgage loans to four other savings and loan associations while simultaneously purchasing 90% participation interests in 305 similar mortgage loans from those four savings and loans.[29] These transactions met the criteria established by Memorandum R-49 and

26. 890 F.2d at 849.

27. 90 T.C. at 374-75.

28. Memorandum R-49, which was issued by the Director of the Office of Examination and Supervision (OES) of the FHLBB on June 27, 1980, contained the following synopsis: "A LOSS NEED NOT BE RECORDED FROM 'RECIPROCAL SALES' OF SUBSTANTIALLY IDENTICAL MORTGAGE LOANS." The Memorandum provided, in part, as follows:

> The purpose of this memorandum is to advise OES staff on the proper accounting for reciprocal sales of mortgage loans.
>
> A loss resulting from a difference between market value and book value in connection with reciprocal sales of substantially identical mortgage loans need not be recorded. Mortgage loans are considered substantially identical only when each of the following criteria is met. The loans involved must:
>
> 1. involve single-family residential mortgages,
> 2. be of similar type (e.g., conventionals for conventionals),
> 3. have the same stated terms to maturity (e.g., 30 years),
> 4. have identical stated interest rates,
> 5. have similar seasoning (i.e., remaining terms to maturity),
> 6. have aggregate principal amounts within the lesser of 2½% or $100,000 (plus or minus) on both sides of the transaction, with any additional consideration being paid in cash,
> 7. be sold without recourse,
> 8. have similar fair market values,
> 9. have similar loan-to-value ratios at the time of the reciprocal sale, and
> 10. have all security properties for both sides of the transaction in the same state.

Id.

29. *See Cottage Savings*, 890 F.2d at 849. The sale of 90% participation interests allowed Cottage Savings to maintain a relationship with the customers whose loans were exchanged by retaining loan documents and processing monthly loan payments. Although most of the mortgage swap cases involved the exchange of 90% participation interests, one case, First Fed. Sav. & Loan Ass'n v. United States, 694 F. Supp. 230 (W.D. Tex. 1988), *aff'd*, 887 F.2d 593 (5th Cir. 1989), considered the exchange of a taxpayer's complete interest in mortgage loans. On appeal, the Fifth Circuit concluded that this difference was not sufficient to differentiate *Temple* from the other mortgage swap cases. *See Temple*, 887 F.2d at 594 (comparing the facts in *Temple* to the 90%

therefore were not reported to the FHLBB as losses affecting net worth.[30] Cottage Savings did, however, report the losses sustained on these sales on its 1980 federal income tax return as deductible losses.[31] The Internal Revenue Service challenged the taxpayer's position, arguing that the transaction did not result in a realized loss because the mortgage loans exchanged were not "materially different."[32]

The Supreme Court began its review of *Cottage Savings* by observing that a taxpayer must engage in a sale or other disposition of property in order to realize gain or loss.[33] The Court noted that the Internal Revenue Code places no "materially different" limitation on the concept of realization, but it nevertheless held that an exchange of properties is an "other disposition" only if the properties exchanged are materially different.[34] The Court's endorsement of Treasury's "materially different" requirement as a reasonable interpretation of statutory language was influenced both by the history of the regulation and by a series of Supreme Court cases described by the *Cottage Savings* Court as "our landmark precedents on realization."[35]

The Court noted that the "sale or other disposition" language currently found in Section 1001(a) was first included in the revenue laws in 1924 and has not been changed since, despite numerous revisions in the law.[36] Recognizing that the regulation which interprets this provision also has remained unchanged since its promulgation in 1935, the Court held that the regulation was entitled to judicial deference.[37]

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participation interests exchanged in a similar case, San Antonio Sav. Ass'n v. Commissioner, 887 F.2d 577 (5th Cir. 1989)).

30. Cottage Savings Ass'n v. Commissioner, 90 T.C. 372, 384 (1988), *rev'd*, 890 F.2d 848 (6th Cir. 1989), *rev'd and remanded*, 111 S. Ct. 1503 (1991).

31. 890 F.2d at 849. Cottage Savings claimed it was entitled to an income tax refund in excess of $677,000 as a result of these exchanges. *See id.*

32. 90 T.C. at 385. In its brief, the government cited two recent Revenue Rulings in support of its position. *See* 111 S. Ct. at 1509 n.7 (citing Rev. Rul. 85-125, 1985-2 C.B. 180 and Rev. Rul. 81-204, 1981-2 C.B. 157, both of which hold that the exchange, or simultaneous purchase and sale, of pools of mortgage loans that do not differ materially either in kind or in extent, does not result in realized gain or loss).

33. *Cottage Savings*, 111 S. Ct. at 1507. The taxpayer in *Cottage Savings* argued that the mortgage swap transactions should be characterized as unrelated sales and purchases. The Tax Court disagreed, holding that the interdependent nature of the transactions compelled it to treat the transaction as an exchange for federal income tax purposes. *See Cottage Savings*, 90 T.C. at 386-87. Other courts reached the same conclusion in connection with their consideration of mortgage swap transactions. *See* San Antonio Sav. Ass'n v. Commissioner, 887 F.2d 577, 581 (5th Cir. 1989) (interdependency of transactions justified characterization as exchange); Centennial Sav. Bank FSB v. United States, 682 F.Supp. 1389, 1396 (N.D. Tex. 1988), *aff'd in part, rev'd in part*, 887 F.2d 595 (5th Cir. 1989), *aff'd in part, rev'd in part*, 111 S. Ct. 1512 (1991) (interdependency of transactions justified characterization as exchange).

34. *Cottage Savings*, 111 S. Ct. at 1508.

35. *Id.*

36. *Id.*

37. *Id.* In so doing, the Court applied a concept known as the reenactment rule: "As we have recognized, 'Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are

The Court also relied on its line of reorganization cases, decided in the twenties, as justification for its adoption of the "materially different" limitation on realization.[38] The Court cited *United States v. Phellis*,[39] *Weiss v. Stearn*,[40] and *United States v. Marr*[41] for the proposition that a taxpayer realizes gain or loss only if the properties exchanged are "materially" or "essentially" different.[42] The Court concluded that the principles of realization previously developed in these cases are now incorporated in the realization requirement as codified in Section 1001(a),[43] and that Treasury's interpretation of this statutory language in a manner consistent with the holdings in these cases must therefore be reasonable.[44]

Having established a limitation on realization of gain or loss, it remained for the Supreme Court to determine whether the interests exchanged by Cottage Savings satisfied the Court's "materially different" standard. The Court refused to adopt the "economic substitute" test advanced by the government,[45] choosing instead to focus on whether the legal entitlements that accompanied the exchanged mortgages were different in kind or extent.[46] The Court held that the mortgage loans received by Cottage Savings provided it with legal entitlements different from those enjoyed prior to the exchange because the loans received were made to different obligors and were secured by different parcels of property. Concluding that the loans exchanged were thus "materially different" because of differences in these legal entitlements, the Court permitted a deduction for the resulting realized loss.[47]

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deemed to have received congressional approval and have the effect of law.' " *Id.* (citing United States v. Correll, 389 U.S. 299, 305-06 (1967), quoting Helvering v. Winmill, 305 U.S. 79, 83 (1938)). For a brief discussion of the reenactment rule, see *infra* note 109.

38. Cottage Sav. Ass'n v. Commissioner, 111 S. Ct. 1503, 1508 (1991).

39. 257 U.S. 156 (1921). *See infra* notes 61-73 and accompanying text for a discussion of this case.

40. 265 U.S. 242 (1924). *See infra* notes 79-89 and accompanying text for a discussion of this case.

41. 268 U.S. 536 (1925). *See infra* notes 89-100 and accompanying text for a discussion of this case.

42. Cottage Sav. Ass'n v. Commissioner, 111 S. Ct. 1503, 1508 (1991).

43. The Court explained its rationale with the following language:

> [b]ecause these decisions were part of the 'contemporary legal context' in which Congress enacted § 202(a) of the 1924 Act, and because Congress has left undisturbed through subsequent reenactments of the Code the principles of realization established in these cases, we may presume that Congress intended to codify these principles in § 1001(a).

Id. at 1508-09 (citations omitted).

44. *Id.*

45. *See infra* notes 175-77 and accompanying text for a discussion of the government's economic substitute theory.

46. *Cottage Savings*, 111 S. Ct. at 1511.

47. *See id.* The Court's decision reversed the Sixth Circuit, which held that although losses incurred by Cottage Savings were realized because the loans exchanged were "materially different," the resulting losses were not deductible under I.R.C. § 165(a) because they were not "sustained during the taxable year" as required by the statute. Cottage Savings Ass'n v. Commissioner, 890 F.2d 848, 855 (6th Cir. 1989), *rev'd and remanded*,

As the Court noted, the "materially different" requirement originated with the Treasury Department's promulgation of interpretive regulations on the subject in 1934.[48] Given the importance of this regulation to the Court's decision in *Cottage Savings*, any analysis of the realization requirement and its possible limitations must begin with a review of the regulation's history and of the cases cited by the Court in support of Treasury's "materially different" requirement.

B. *The Treasury Regulations*

As the Supreme Court noted in *Cottage Savings*, current Treasury Regulations provide that "the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained."[49] Although this language was first included in the regulations in 1935, Treasury addressed the issue of realization much earlier with the promulgation of regulations pursuant to Section 202(b) of the Revenue Act of 1918, a provision that treated property received in an exchange as the equivalent of cash for purposes of determining gain or loss.[50] Treasury's interpretation of this section of the Act appeared the following year:

> Gain or loss arising from the acquisition and subsequent disposition of property is realized when as the result of a transaction between the owner and another person the property is converted into cash or into property (a) that is essentially different from the property disposed of, and (b) that has a market value. In other words, both (a) a change in substance and not merely in form, and (b) a change into the equivalent of cash, are required to complete or close a transaction from which income may be realized.[51]

Treasury's adoption of this "essentially different" requirement was apparently based on the concept of substance over form, given the reference to this concept in both the regulations and the legislative history of Section 202(b).[52] Reliance on congressional intent may have been misplaced, however, because the legislative history of Section 202(b) suggests

111 S. Ct. 1503 (1991). While the Supreme Court offered no explanation for its disagreement with the Sixth Circuit on this issue, it did note that the government raised this issue on appeal in a one-sentence footnote to its brief. *See Cottage Savings*, 111 S. Ct. at 1511-12. This suggests that the issue might have received more attention from the Court if the government had offered a better argument in favor of the Sixth Circuit's conclusion.

48. Cottage Sav. Ass'n v. Commissioner, 111 S. Ct. 1503, 1508.

49. *Id.* (quoting Treas. Reg. § 1.1001-1(a) (as amended in 1972)).

50. Section 202(b) provided that "[w]hen property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any." Revenue Act of 1918, Pub. L. No. 65-254, § 202(b), 40 Stat. 1057, 1060 (1919).

51. Treas. Reg. No. 45, Art. 1563, 21 Treas. Dec. Int. Rev. 170, 393 (1919).

52. The Senate Finance Committee Report on section 202(b) of the Revenue Act of 1918 contained an indirect reference to the concept of substance over form. For an excerpt from the text of this report, see *infra* note 53.

that lawmakers' concern with substance over form was limited to reorganization transactions.[53]

The "essentially different" standard appeared in an amended version of the same regulation in 1920,[54] and again in 1922 when the regulations were repromulgated.[55] The property exchange provision was subsequently eliminated from the regulations, however, presumably in response to changes made by lawmakers in the Revenue Act of 1924 with respect to the realization of gain or loss.[56] No reference to the tax treatment of property exchanges appeared in the regulations again until 1935.[57]

53. A proviso following the general rule in section 202(b) added that no gain or loss shall be deemed to occur from the exchange in those transactions involving a reorganization, merger, or consolidation of a corporation. *See* Revenue Act of 1918, Pub. L. No. 65-254, § 202(b), 40 Stat. 1057, 1060 (1919). The following excerpt from the legislative history provides some useful background on this provision (the predecessor of a current nonrecognition provision, I.R.C. § 354):

> A provision was inserted designed to establish the rule for determining taxable gains in the case of exchanges of property and to negative the assertion of tax in the case of certain *purely paper transactions.* The substance of this provision is that when property is exchanged for other property the property received in exchange shall be treated as the equivalent of cash to the amount of its fair market value, but when in connection with the reorganization or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par value, or when a person receives in place of property stock of a corporation formed to take over such property, no gain or loss shall be deemed to occur from the exchange.

S. Rep. No. 617, 65th Cong., 3d Sess. 5-6 (1919) (emphasis added). Given the lengthy discussion of the tax consequences of a reorganization in the Senate Report, it appears that the Report's reference to "purely paper transactions" may have been limited to reorganizations. It is interesting to note that while the reference in section 202(b) to "gain or loss deemed to occur" made no distinction between realized and recognized gain, Treasury's "essentially different" requirement did so by clearly limited realization. *See supra* text accompanying note 51.

54. Treas. Dec. 2971, 22 Treas. Dec. Int. Rev. 19 (1920).

55. Treas. Reg. No. 62, Art. 1564, 24 Treas. Dec. Int. Rev. 207, 498 (1922).

56. In 1924, the Congress changed the approach previously taken with respect to gains and losses by eliminating the provision limiting realization whenever the fair market value of the property received was uncertain. *See supra* text accompanying note 51. The 1924 Act provided that "gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis [of the property]." Revenue Act of 1924, Pub. L. No. 68-176, § 202(a), 43 Stat. 253, 255 (1924).

In a brief filed with the Supreme Court, Cottage Savings suggested that "[t]he 1920 regulation was inconsistent with Congress' intent to create a rule of certainty in Section 203; thus, it was properly abandoned." Brief for Petitioner at Part II.A.3 of the Argument, Cottage Sav. Ass'n v. Commissioner, 111 S. Ct. 1503 (1991) (No. 89-1965).

The Treasury Department also may have removed its guidelines on property exchanges from the regulations in the early twenties because of a perceived conflict with the tests announced by the Supreme Court in United States v. Phellis, 257 U.S. 156 (1921), and Weiss v. Stearn, 265 U.S. 242 (1924). If correct, this would explain why a provision addressing exchange transactions reappeared after consideration of the issue was completed by the Supreme Court in Marr v. United States, 268 U.S. 536 (1925).

57. *See, e.g.*, Treas. Reg. No. 65, Art. 1561, (1924)(discussing exchange of "like kind" property); Treas. Reg. No. 74, Art. 561, (1930)(same); Treas. Reg. No. 77, Art. 561, (1934)(same).

In 1935, Treasury promulgated regulations pursuant to the Revenue Act of 1934. Those regulations addressed the question of realization in property exchanges with the following language: "Except as otherwise provided, the Internal Revenue Code regards as income or as loss sustained, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent."[58] This language has remained virtually unchanged since its original adoption by the Treasury Department in 1935.[59]

Treasury's adoption of the "materially different" standard in 1935 remains a mystery. Since the standard's adoption, Treasury has not discussed its origin and has offered no definition of "materially different." Despite the uneasy footing of Treasury's standard, however, the Supreme Court suggested in *Cottage Savings* that Treasury's limitation on realization does find support in a series of Supreme Court cases dealing with the tax consequences of corporate reorganizations.

C. *The Reorganization Cases*

Following its landmark decision in *Eisner v. Macomber*,[60] the Court considered a series of stock-for-stock exchange cases that were subsequently relied upon by the Court in *Cottage Savings* when it adopted the "materially different" limitation on realization.

The first of these cases, *United States v. Phellis*,[61] involved a taxpayer who owned 250 shares of the common stock of E.I. du Pont de Nemours Powder Company, a New Jersey corporation.[62] Pursuant to a reorganization plan, the company transferred substantially all of its assets to a newly-formed Delaware corporation in exchange for approximately half of the new corporation's authorized capital stock.[63] The New Jersey corporation then distributed Delaware corporation stock on a pro rata basis to the taxpayer and all other New Jersey corporation shareholders as a "dividend."[64] The taxpayer was not required to relinquish his shares in the New Jersey corporation.[65] The New Jersey corporation continued in existence but conducted no further business.[66]

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58. Treas. Reg. No. 86, Art. 111-1 (1934).

59. This language later appeared in regulations under the Revenue Act of 1936, Treas. Reg. No. 94, Art. 111-1, and regulations issued under the Internal Revenue Code of 1939, Treas. Reg. § 19.111-1. Almost identical language currently appears in Treas. Reg. § 1.1001-1(a) (1972). *See supra* note 23 and accompanying text.

60. 252 U.S. 189 (1920). For a discussion of this case, see *supra* notes 14-19 and accompanying text.

61. 257 U.S. 156 (1921).

62. *Id.* at 165-66.

63. *Id.* at 166. As partial consideration for the transfer of its operating assets, the New Jersey corporation retained approximately $1.5 million in cash which it in turn used to redeem its 5% mortgage bonds. *See id.*

64. 257 U.S. at 166.

65. *Id.* at 167.

66. *Id.*

In an opinion authored by Justice Pitney, the Court held that because stock in the Delaware corporation was held by the New Jersey corporation in recognition of the transfer of assets to the new corporation, that stock constituted an asset of the New Jersey corporation which, when distributed to its shareholders, resulted in a severance of a portion of the taxpayer's investment in the New Jersey corporation.[67] In applying this concept of severance—which, as the Court noted, was adopted in *Eisner v. Macomber*[68]— the *Phellis* Court concluded that:

> when this common stock was distributed among the common stockholders of the old company as a dividend, then at once—*unless the two companies must be regarded as substantially identical*—the individual stockholders of the old company, including claimant, received assets of exchangeable and actual value severed from their capital interest in the old company, proceeding from it as the result of a division of former corporate profits, and drawn by them severally for their individual and separate use and benefit.[69]

Noting that the corporations were chartered in different states and that the interests of existing stockholders in the business were significantly diluted as a result of the transaction,[70] the Court held that the two corporations were not substantially identical,[71] and that thus the stock received by the taxpayer must be characterized as income.[72] Specifically, the Court concluded:

> In the light of all this we cannot regard the new company as virtually identical with the old, but must treat it as a substantial corporate body with its own separate identity, and its stockholders as having property rights and interests *materially different* from those incident to ownership of stock in the old company.[73]

The Court relied on *Phellis* when it refused to limit realization in two subsequent cases, *Rockefeller v. United States*[74] and *Cullinan v. Walker*,[75] both involving facts similar to those in *Phellis*.[76] Both decisions were based on the approach taken in *Phellis*: the stock received by

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67. *Id.* at 170.
68. 257 U.S. at 169.
69. *Id.* at 170 (emphasis added).
70. For a discussion of this issue, see *infra* note 89.
71. *See Phellis*, 257 U.S. at 173. The Court observed that the authorized capital of the new corporation was nearly four times that of the old corporation, with less than half of the new shares issued to the existing shareholders. This left "the future disposition of a majority of the authorized new issues still to be determined," according to the Court. *Id.*
72. *Id.* at 175.
73. *Id.* at 173 (emphasis added).
74. 257 U.S. 176 (1921).
75. 262 U.S. 134 (1923).
76. In *Rockefeller*, the stockholders of Prairie Oil & Gas Company, a Kansas corporation, organized a new Kansas corporation for the purpose of operating Prairie's pipeline business. The stock of the new corporation was distributed, pro rata, to the stockholders of Prairie. *See Rockefeller*, 257 U.S. at 181. In *Cullinan*, the trustee appointed to oversee the liquidation of a corporation formed two Texas corporations for the purpose of operating the business of the liquidated corporation. The stock of these two

the taxpayer was held by the distributing corporation as a substitute for assets which, when distributed to the stockholder, resulted in the realization of income.[77] Although there is no mention in these later decisions of the "substantially identical" or "materially different" standards adopted by the Court in *Phellis*, the Court's discussion of factors distinguishing the corporations involved in these cases, together with the reliance placed on *Phellis*, suggest that the absence of "substantially identical" corporations was instrumental in these decisions.[78]

The Court reached a different result, however, in *Weiss v. Stearn*.[79] The taxpayer in *Weiss* held stock in National Acme Manufacturing Company, an Ohio corporation.[80] Pursuant to a written agreement, all of the assets, contracts, and liabilities of the company were transferred to a new Ohio corporation formed for the purpose of conducting the business of National Acme.[81] The new corporation transferred all of its authorized and outstanding stock to a trust company in consideration for the receipt of National Acme's business.[82] The taxpayer and all other shareholders of National Acme exchanged their shares through the trust company for cash (contributed by new investors) and stock of the new corporation.[83] Finally, National Acme was liquidated.[84] The government characterized the transaction as a sale by each shareholder of his interest in the old corporation for cash and newly-issued stock.[85]

Writing for the Court, Justice McReynolds held that the Court's decision in *Phellis* did not apply to the stock-for-stock exchange in *Weiss*. Although the Court acknowledged that the taxpayer realized gain on that portion of the stock exchanged for cash, it concluded that because National Acme did not segregate its assets and distribute them to its shareholders in the form of stock, as was done by du Pont of New Jersey in *Phellis*, the exchange of stock for stock was not a taxable event.[86]

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corporations was issued to a newly-formed Delaware corporation which was wholly-owned by the trustee. *See Cullinan*, 262 U.S. at 136.

77. *See Rockefeller*, 257 U.S. at 183-84; *Cullinan*, 262 U.S. at 137-38.
78. *See Rockefeller*, 257 U.S. at 183-84; *Cullinan*, 262 U.S. at 137-38.
79. 265 U.S. 242 (1924).
80. *See id.* at 251.
81. *See id.*
82. *See Weiss*, 265 U.S. at 251.
83. *See id.* at 252.
84. *See id.* at 251.
85. *See id.* at 252.
86. *See id.* at 252-53 (suggesting that the decisions in *Phellis* and *Rockefeller* did not apply to the facts of *Weiss*). The *Weiss* Court also concluded that the decision reached in *Cullinan* was not controlling because that case involved the receipt of stock in a holding company that did not hold title to the assets of the old company and did not carry on the business of the old company. *See id.*

Although not highlighted by the Court, there are two other significant factual differences between *Phellis* and *Weiss* that arguably justify the result reached by the *Weiss* Court. First, the National Acme stock was surrendered to a trust company, leaving the impression that the new shares received by the taxpayer were intended to act as a substitute for the investment represented by the old shares. *See* Weiss v. Stearn, 265 U.S. 242, 251-52 (1923). In other words, the *Weiss* case did not involve a distribution of assets

Rather than deciding, as it did in *Phellis*, whether or not the two corporations were "substantially identical," the *Weiss* Court focused exclusively on the nature of the interest received by the taxpayer. Thus, the Court held that:

> [the Court] can not conclude that mere change for purposes of reorganization in the technical ownership of an enterprise, under circumstances like those here disclosed, followed by issuance of new certificates, constitutes gain separated from the original capital interest. *Something more is necessary—something which gives the stockholder a thing really different from what he theretofore had.*[87]

Noting that the transaction left the taxpayer with an interest in the enterprise identical to the interest relinquished,[88] the Court held that the exchange did not result in realized gain or loss.[89]

The last of the reorganization cases, *Marr v. United States*,[90] involved the decision of General Motors of New Jersey to reincorporate in the state of Delaware.[91] Pursuant to a reorganization plan, the taxpayer relinquished his stock in the New Jersey corporation and in exchange re-

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made *with respect to* the taxpayer's investment in another corporation, as was the case in *Phellis*. *See* United States v. Phellis, 257 U.S. 156, 170 (1921). Second, the plan of reorganization in *Weiss* included the liquidation of National Acme, while the plan in *Phellis* did not contemplate a liquidation of the old corporation. *See Weiss*, 265 U.S. at 251-52; *Phellis*, 257 U.S. at 167. Thus, the transaction in *Phellis* left the taxpayer with two different assets: New Jersey corporation stock and Delaware corporation stock. The Court's decision in *Weiss* clearly was influenced by the fact that the reorganization transaction did not leave the taxpayer with two different property interests as did the transaction in *Phellis*. *See Weiss*, 265 U.S. at 254; *Phellis*, 257 U.S. at 173.

87. Weiss v. Stearn, 265 U.S. 242, 254 (1924) (emphasis added). It is interesting to note that the Court cites three cases in support of this conclusion, none of which directly endorse the test adopted by the Court in *Weiss*. *See* Towne v. Eisner, 245 U.S. 418, 426-27 (1918) (some change in a shareholder's interest is required for the transaction to constitute an exchange); Southern Pac. Co. v. Lowe, 247 U.S. 330, 336 (1918) (some change in shareholder interest required); Gulf Oil Corp. v. Lewellyn, 248 U.S. 71 (1918) (no mention of change in interest in Court's opinion).

88. *Weiss*, 265 U.S. at 254.

89. *Id.* The Court's holding was limited to that portion of the taxpayer's interest that was maintained in the form of stock. *See id.* The Court agreed that gain was realized to the extent that the taxpayer received cash in exchange for stock held in the old corporation. *See id.* at 252.

Speculating on the results of a hypothetical transfer, the *Weiss* Court stated that:

> [i]f upon the transfer of its entire property and business for the purpose of reorganization and future conduct the old corporation had actually received *the entire issue* of new stock and had then distributed this pro rata among its stockholders, their ultimate rights in the enterprise would have continued substantially as before - the capital assets would have remained unimpaired and nothing would have gone therefrom to any stockholder for his separate benefit. The value of his holdings would not have changed, and he would have retained the same essential rights in respect of the assets.

Id. at 253 (emphasis added). Thus, it appears that the potential dilution of the interests held by the shareholders in the business of du Pont of New Jersey was a key factor in the Court's decision in *Phellis*.

90. 268 U.S. 536 (1925).

91. *See id.* at 538-39.

ceived stock in the newly-formed Delaware corporation.[92] All of the assets and liabilities of the New Jersey corporation were transferred to the Delaware corporation, and the New Jersey corporation was subsequently liquidated.[93]

The *Marr* Court began by noting that although each of the reorganization cases previously considered by the Court dealt with businesses that were not changed by the transaction in question, the three cases which characterized stock distributions as income (*Phellis*, *Rockefeller*, and *Cullinan*) involved transactions resulting in a change in corporate identity.[94] Noting that no change in identity occurred in the other two reorganization cases, *Weiss* and *Macomber*,[95] the Court concluded that the disparate results reached in these two sets of cases justified its focus on the change in corporation identity.[96]

Citing state of incorporation as the key factor, the *Marr* Court held that the Delaware corporation was "essentially different" from the New Jersey corporation. The Court stated that:

> [a] corporation organized under the laws of Delaware does not have the same rights and powers as one organized under the laws of New Jersey. Because of these inherent differences in rights and powers, both the preferred and the common stock of the old corporation is an essentially different thing from the stock of the same general kind in the new.[97]

Although the Court assigned some significance to the nature of the interests exchanged by the taxpayer,[98] as it did in *Weiss*,[99] it relied primarily on the fact that the two corporations were formed in different states.[100]

92. *Id.* at 538.

93. *Id.* at 539.

94. *Id.* at 540 (1925). "That is, the corporate property, or a part thereof, was no longer held and operated by the same corporation; and after the distribution, the stockholders no longer owned merely the same proportional interest of the same character in the same corporation." *Id.*

95. The Court observed that in *Macomber*, there was no second corporation involved in the transaction, and in *Weiss*, "[t]echnically there was a new entity; but the corporate identity was deemed to have been substantially maintained because the new corporation was organized under the laws of the same State, with presumably the same powers as the old." *Id.* at 541.

96. *See id.* at 540-41.

97. *Id.* at 541.

98. The taxpayer in *Marr* exchanged 7% voting preferred stock in the New Jersey corporation for 6% non-voting preferred stock in the Delaware corporation. *See* Marr v. United States, 268 U.S. 536, 538 (1925). Although the Court concluded that "[a] 6 per cent. non-voting preferred stock is an essentially different thing from a 7 per cent. voting preferred stock," it described this as an "adventitious" difference, "substantial in character." *Id.* at 541.

99. *See supra* note 87 and accompanying text.

100. *See Marr*, 268 U.S. at 541-42. The Court's reliance on state of incorporation as a means of distinguishing between its decisions in previous cases was based on the fact that in *Weiss*, the only fact pattern involving two corporations chartered in the same state, the stock received by the taxpayer was treated as a substitute for the stock relinquished. *See* Weiss v. Stearn, 265 U.S. 242, 253-54 (1924). Interestingly, Justice McReynolds, the

The *Marr* Court thus concluded that the taxpayer realized gain upon receipt of stock in General Motors of Delaware.[101]

With the historical development of the "materially different" standard as background, two questions remain. First, do the early Supreme Court cases establish the existence of a limitation on the concept of realization? Second, do they also endorse Treasury's "materiality" test as an appropriate method of applying this limitation? These questions will be considered in the discussion that follows.

III. JUSTIFYING A LIMITATION ON REALIZATION

The concept of realization was developed by the Supreme Court in *Macomber* as a means of differentiating between appreciation still a part of the taxpayer's capital investment and "gain . . . *received* or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal."[102] Although the reference in both the sixteenth amendment and section 61(a) of the Code to "income, from whatever source derived" is purposefully broad, the triggering "realization" event must be confined to transactions that fix the appreciation inherent in the asset and isolate it from the underlying capital investment.[103] Any "sale or other disposition" will satisfy these requirements and be considered a "taxable event" resulting in the realization of gain or loss.[104] The question, then, is whether an exchange of properties will ever fail to qualify as an "other disposition" and thereby illustrate that the concept of realization is subject to limitation based on the nature of the transaction.[105]

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author of the opinion in *Weiss*, joined in a separate opinion issued in *Marr* in which he and three other justices expressed concern over the majority's reliance on state of incorporation. In the relevant portion of their separate opinion, the justices stated that:

> *Weiss v. Stearn* did not turn upon the relatively unimportant circumstance that the new and old corporations were organized under the laws of the same State, but upon the approved definition of income from capital as something severed therefrom and received by the taxpayer from his separate use and benefit. Here stockholders got nothing from the old business or assets except new statements of their undivided interests, and this, as we carefully pointed out, is not enough to create taxable income.

Marr, 268 U.S. at 542. Based on this explanation of the majority's reasoning in *Weiss*, it appears that the *Weiss* Court would have decided *Marr* differently. What the minority in *Marr* fail to explain is why tax-free treatment is appropriate, given the fact that the transaction in *Marr* left the taxpayer with nonvoting stock, an "essentially different thing" than the voting stock relinquished in the exchange. *See id.* at 541.

101. *Id.* at 541-42.

102. Eisner v. Macomber, 252 U.S. 189, 207 (1920)(emphasis in original). *See supra* note 16 and accompanying text.

103. In other words, unrealized appreciation is not "income" for purposes of the Sixteenth Amendment. *See supra* note 17.

104. In *Cottage Savings*, the Supreme Court conditioned realization on a sale or other disposition: "Section 1001(a)'s language provides a straightforward test for realization: to realize a gain or loss in the value of property, the taxpayer must engage in a 'sale or other disposition of [the] property.'" Cottage Sav. Ass'n v. Commissioner, 111 S. Ct. 1503, 1507 (1991).

105. In his book *Taxable Income*, Professor Magill presents another possible limitation

A. *Judicial Support for a Limitation on Realization*

The analysis of a property exchange transaction must begin with a review of the substance of the transaction. If an exchange represents a true "disposition of property," it will result in the realization of gain or loss.[106] Whether every property exchange transaction should be characterized as a disposition of property is considered below.

The Supreme Court adopted the "materially different" limitation on realization in *Cottage Savings* in concluding that, as embodied in Treasury Reg. Section 1.1001-1(a), the limitation was a reasonable interpretation of the realization requirement implicit in Section 1001(a) of the Code.[107] The Court's conclusion was based, in part, on its observation that the regulation had received Congressional approval through inaction.[108] Although the Supreme Court made legitimate use of the "reenactment rule" when it adopted Treasury's "materially different" test in *Cottage Savings*,[109] endorsement of a controversial provision in this man-

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on the concept of realization. *See* R. Magill, Taxable Income 126 (rev. ed. 1945) [hereinafter Magill]. Professor Magill suggests that the open transaction doctrine established by the Supreme Court in Burnet v. Logan, 283 U.S. 404 (1931), lends support to the position that a sale or other disposition involving property with no ascertainable fair market value does not constitute a realization event, because the equivalent of cash has not been received. *See* Magill, *supra*, at 126.

The revenue laws and supporting Treasury Regulations originally conditioned realization on the receipt of property with an ascertainable market value. *See* Revenue Act of 1918, Pub. L. No. 254, § 202(b), 40 Stat. 1057 (1919); Revenue Act of 1921, Pub. L. No. 98, § 202(c), 42 Stat. 227 (1921); Treas. Reg. No. 45, Art. 1563 (1918). *See also supra* note 51 and accompanying text. Those guidelines were abandoned in 1924 when Congress statutorily defined "amount realized" to include the fair market value of property other than money received in a transaction. *See* Revenue Act of 1924, Pub. L. No. 68-176, § 202(c), 43 Stat. 253, 255 (1924), discussed *supra* note 56.

Currently, Treasury takes the position that "[t]he fair market value of property is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value." Treas. Reg. § 1.1001-1(a) (as amended in 1972). Caselaw supports Treasury's position by endorsing a method of valuing property which assumes that, in an arm's length exchange between unrelated parties, the value of property received can be determined with reference to the property exchanged. *See* United States v. Davis, 370 U.S. 65, 72 (1962); International Freighting Corp. v. Commissioner, 135 F.2d 310, 313 (2d Cir. 1943); Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184, 188-89 (Ct. Cl. 1954). Consequently, it is questionable whether the Cash Equivalence Doctrine is recognized today as a limitation on the concept of realization.

106. *See Cottage Savings*, 111 S. Ct. at 1507.

107. *Id.* at 1508. The circuit courts also endorsed the "materially different" test during their consideration of the mortgage swap cases. *See* San Antonio Sav. Ass'n v. Commissioner, 887 F.2d 577, 586-87 (5th Cir. 1989); First Fed. Sav. & Loan Ass'n of Temple v. United States, 887 F.2d 593, 595 (5th Cir. 1989); Centennial Sav. Bank FSB v. United States, 887 F.2d 595, 600 (5th Cir. 1989), *aff'd in part, rev'd in part*, 111 S. Ct. 1512 (1991); Cottage Sav. Ass'n v. Commissioner, 890 F.2d 848 (6th Cir. 1989), *rev'd and remanded*, 111 S. Ct. 1503, 1508 (1991); FNMA v. Commissioner, 896 F.2d 580, 583 (D.C. Cir. 1990).

108. *See Cottage Savings*, 111 S. Ct. at 1508.

109. The reenactment rule is a concept employed by the courts which creates a presumption in favor of the validity of regulations promulgated by an administrative agency which interpret a statute that is reenacted without change after issuance of the regulations. *See, e.g.*, Helvering v. Winmill, 305 U.S. 79, 83 (1938) ("Treasury regulations and

ner leaves many questions unanswered.

To its credit, the Court also relied on its "landmark realization cases," a body of caselaw that both confirms and justifies the existence of a limitation on the concept of realization.[110] In *Weiss*, the Supreme Court held that a technical change in ownership evidenced by an exchange of essentially identical interests did not constitute "gain separated from the original capital interest."[111] In so doing, the Court acknowledged that not all exchange transactions will be treated as realization events for tax purposes.

Although the Court reached a different result in *Phellis* and *Marr*, these cases also provide support for the existence of a limitation on realization. In both cases, the Court implicitly acknowledged the existence of a limitation on realization by comparing the interests exchanged. Just as similarities between interests justified the result in *Weiss*, differences between the interests exchanged in *Phellis* and *Marr* justified characterization of those transactions as realization events. Although the *Phellis* and *Marr* Courts applied this "materially different" standard primarily at the corporate level[112]—in contrast to the standard's application at the shareholder level in *Weiss*[113]—all three decisions reflect the Court's concern over the differences between the corporations involved in the transactions and the effects of those differences on the ownership interests held by stockholders.

While these cases seem to stand together in support of an evaluation of properties involved in an exchange, some important factual differences should be noted. In *Phellis*, the Court applied a "materially different" test to a corporate distribution transaction.[114] Consequently, the Court's use of this standard to compare the two corporations involved in the *Phellis* transaction should be viewed as a method of characterizing distributions made by a corporation with respect to its stock, and not as a decision affecting the way in which the concept of realization is applied in property exchange cases. Although the Court's decision in *Marr* does support use of the "materially different" standard in exchange cases, the

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interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law.").

110. *See Cottage Savings*, 111 S. Ct. at 1508.

111. Weiss v. Stearn, 265 U.S. 242, 254 (1924).

112. *See* Marr v. United States, 268 U.S. 536, 541 (1925); United States v. Phellis, 257 U.S. 156, 175 (1921). Although the *Marr* Court based its evaluation primarily on differences between the two corporations involved in the transaction, it also relied on the nature of the equity interests exchanged. *See Marr*, 268 U.S. 536, 541; *supra* note 98.

113. Presumably, the *Weiss* Court chose to focus on the nature of the stock involved in the exchange because of its conclusion, implicit in its decision and confirmed by the Court's subsequent decision in *Marr*, that the two corporations were, in substance, identical. *See supra* note 88 and accompanying text.

114. *See Phellis*, 257 U.S. at 168.

Court's rationale was undermined by the strong dissent in the case.[115] Still, *Marr* supports some limitation on realization in property exchange transactions, given the Court's decision to evaluate the exchange transaction using a standard based on a comparison of the characteristics of the properties exchanged.[116] In addition, *Marr* is cited as authority for the idea that this limitation on realization also applies to different interests in the same property.[117] Notwithstanding these differences, these cases combine to provide convincing justification and support for recognition of a limitation on the concept of realization based on the nature of the properties involved in the exchange.

Other courts have properly characterized the approach taken by the Supreme Court in these cases as an application of the doctrine of substance over form.[118] As the Court's decision in *Weiss* illustrates, a transaction which in form qualifies as an "other disposition" and therefore should result in realized gain or loss will not be treated as a disposition if, in substance, it is merely an exchange of identical property interests. Thus, it is appropriate to view *Phellis*, *Weiss*, and *Marr* as cases that establish some limitation on the meaning of realization through an interpretation of "other disposition" and "exchange" as those terms are used currently in Code Sections 1001(a) and (c). Together, these cases demonstrate that a transaction which in substance results in the disposition of an interest in property (rather than a substitution of one interest for an identical one) will be treated as a taxable event resulting in realized gain or loss.[119] Thus, the early Supreme Court cases suggest that it is both conceptually and administratively proper to limit realization in

115. For a discussion of the position taken by several justices in a separate opinion in *Marr*, see *supra* note 100.

116. Although the *Marr* Court relied primarily on differences between the two corporations to justify its decision, it also noted that the exchange involved the receipt of nonvoting stock for voting stock. *See supra* note 98. Thus, the reasoning of the Court in *Marr* appears similar to that of the Second Circuit in Emery v. Commissioner, 166 F.2d 27 (2d Cir. 1948). In *Emery*, the court found that a difference in the terms of refinancing bonds used to replace those originally issued justified realization of income. *See id.* at 29-30.

117. *See* Cottage Sav. Ass'n v. Commissioner, 111 S. Ct. 1503, 1510 (1991); San Antonio Sav. Ass'n v. Commissioner, 887 F.2d 577, 585 (5th Cir. 1989). The Fifth Circuit in *San Antonio* rejected the taxpayer's argument that these reorganization cases limited the application of the "materially different" test to exchanges of different interests in the same property. *See id.*

118. *See San Antonio*, 887 F.2d at 577; Centennial Sav. Bank FSB v. United States, 682 F. Supp. 1389, 1396 (N.D. Tex. 1988), *aff'd in part, rev'd in part*, 887 F.2d 595 (5th Cir. 1989), *aff'd in part, rev'd in part*, 111 S. Ct. 1512 (1991). The Supreme Court has recognized the doctrine of substance over form in a number of cases. *See, e.g.*, Deidrich v. Commissioner, 457 U.S. 191, 195 (1982) ("[S]ubstance, not the form, of the agreed transaction controls."); Commissioner v. P.G. Lake, Inc., 356 U.S. 260, 266-67 (1958)(stating that the substance of arrangements is determined "not by subtleties of draftmanship but by their total effect"); Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945)("The incidence of taxation depends upon the substance of a transaction.").

119. *See* Weiss v. Stearn, 265 U.S. 242, 254 (1924).

property exchange transactions to those exchanges that are in substance true dispositions, because such exchanges involve different properties.

B. *The Case Against Limitations on Realization*

The Supreme Court's opinion in *Cottage Savings* focused exclusively on authorities supporting the existence of a limitation on realization, and omitted any discussion of issues raised by the taxpayer and others.[120] Lower court decisions rendered in *Cottage Savings* and similar cases did, however, consider other issues raised by the parties in some detail. A review of the issues raised by opponents of the "materially different" standard provides additional perspective on and support for the Supreme Court's endorsement of the test.

1. Disregarding the Nature of the Properties Exchanged

Naturally, the taxpayers who claimed losses in connection with the exchange of mortgage loans argued against the use of a "materially different" limitation on realization. Recognizing that these loans, which qualified as "substantially identical" for purposes of Memorandum R-49,[121] might not qualify as "materially different," the taxpayers argued that any disposition will trigger realization, regardless of the consideration received in exchange.[122] The trial court in *First Federal Savings & Loan Association of Temple v. United States*[123] subscribed to this approach:

> [T]he concept of realization has two distinct, component aspects which must both be satisfied before a gain or loss is 'realized' for tax purposes. First, there is the economic (or what can be called the 'common sense') aspect of realization. That is, 'Has there been an actual economic gain or loss?' This is generally put in terms of an economic increase or decrease in a taxpayer's net worth. This aspect has often been summed up by the famous paraphrase from *Eisner v. Macomber*, 'Is the taxpayer, in fact, richer or poorer?' Second, there is the practical accounting aspect of realization. Namely, that for accounting and valuation purposes the increase or decrease in a taxpayer's net worth (*i.e.* the value of his assets) will not be accounted for ('realized' as a practical matter) until there is some 'event that freezes or fixes the gain with sufficient certainty so that it is proper to tax it. . . . A taxable event, under the Code, which suffices to satisfy the second aspect of realization is a 'sale or other disposition of property' or a 'sale or ex-

120. No amicus briefs were filed in *Cottage Savings*. In *Centennial*, amicus briefs were filed by a number of financial institutions and associations. *See* United States v. Centennial Sav. Bank FSB, 111 S. Ct. 1512 (1991) (No. 89-1965).

121. *See supra* note 28 and accompanying text (discussing the FHLBB's Memorandum R-49).

122. *See* Cottage Sav. Ass'n v. Commissioner, 890 F.2d 848, 850 (6th Cir. 1989), *rev'd and remanded*, 111 S. Ct. 1503 (1991); First Fed. Sav. & Loan Ass'n of Temple v. United States, 694 F. Supp. 230, 240 (W.D. Tex. 1988), *aff'd*, 887 F.2d 593 (5th Cir. 1989).

123. 694 F. Supp. 230 (W.D. Tex. 1988).

change of property.'[124]

The District Court's literal interpretation of the "sale or other disposition" requirement in *Temple* has two faults, however. First, it places complete responsibility for distinguishing between legitimate and "manufactured" transactions on the nonrecognition provisions included in the Internal Revenue Code.[125] As noted by the Fifth Circuit in *San Antonio Savings Association v. Commissioner*,[126] a similar case heard by the Court concurrently with appeals in *Temple* and a third mortgage swap case, *Centennial Savings Bank FSB v. United States*,[127] such a position is flawed because it:

> places no limits on realization through meaningless exchanges. Realization of gain or loss would occur if farmer A exchanged 1,000 bushels of Kansas spring wheat with farmer B for 1,000 bushels of Kansas spring wheat or if individual C exchanged his 1969 red Ferrari with individual D's 1969 red Ferrari (of the same model), both of which had been garaged and never driven. As [San Antonio Savings Association, the taxpayer here] acknowledges, this doctrine would lead to deduction of the losses sustained on these transactions absent a specific Code non-recognition provision.[128]

Clearly, the approach offered by the Court in *Temple* would sanction realization in those transactions described by the Fifth Circuit. Although concern over the approach endorsed in *Temple* is easily addressed with legislation restricting the deduction of losses resulting from these types of transactions,[129] use of nonrecognition provisions in all such cases is inconsistent with the original purpose of these provisions.[130]

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124. *Id.* at 239 (citations omitted).

125. *See infra* notes 139-47 and accompanying text for a discussion of the *Temple* court's view on the role of nonrecognition provisions.

126. 887 F.2d 577 (5th Cir. 1989).

127. 887 F.2d 595 (5th Cir. 1989).

128. *San Antonio*, 887 F.2d at 583. *Cf.* Horne v. Commissioner, 5 T.C. 250, 255-56 (1945) (no gain or loss realized on sale of seat on commodities exchange; sale and earlier purchase of identical seat treated as exchange of identical interests).

129. The Internal Revenue Code currently limits recognition of losses realized in connection with a variety of transactions. *See, e.g.*, I.R.C. § 267(a) (losses incurred in transactions between related parties disallowed); I.R.C. § 1091(a) (losses incurred in wash sales transactions disallowed); I.R.C. § 165(c) (certain losses incurred by individuals disallowed).

130. For example, in considering § 112 of the Revenue Act of 1934, Pub. L. No. 73-216, § 112, 48 Stat. 680, 704 (1934), the predecessor of current I.R.C. § 1031(a), the Ways and Means Subcommittee observed that the like kind exchange rules were intended to postpone recognition of gain or loss until such time as a "pure sale" occurred:

> The underlying principle behind all of the exchange and reorganization provisions of the present law is that they do not result in tax exemption, but that the tax is postponed until a gain is realized from a pure sale or what amounts to a pure sale. The reasons assigned for such a policy are: (1) that such provisions prevent much of the uncertainty and litigation which was involved in the prior income tax laws; (2) normal business adjustments will not be interfered with if so-called "paper profits" are exempted; (3) the revenues of the Government will be increased by preventing taxpayers from taking colorable losses.

Of greater concern is the lack of attention given the substance of the transaction by the two-part test announced in *Temple*. As noted by the Supreme Court in *Weiss*, if the taxpayer does not receive a "thing really different" from that exchanged, the transaction does not constitute a realization event.[131] Although the *Weiss* Court found that the interests exchanged in that case were technically identical,[132] a different result would have been reached in that case had the Court focused on the formal termination of the taxpayer's interest in the old corporation.[133] Thus, *Weiss* dictates that a disposition of property will trigger realization only if it provides the taxpayer with something that is, in substance, "really and truly different" than what was held before the exchange.[134] The approach advocated by the District Court in *Temple* fails to consider the substance of an exchange transaction and therefore must be eliminated as a means of evaluating exchange transactions.

2. Realization vs. Recognition: Conflicting Provisions

At first glance, the Supreme Court's endorsement of the "materially different" limitation on realization appears to conflict with nonrecognition provisions found in the Code.[135] This observation, which was raised by the taxpayer in *Cottage Savings*,[136] suggests that limiting realization by evaluating the properties subject to an exchange undermines these nonrecognition provisions by doing what they were enacted to do: limit the imposition of tax on gain or loss resulting from the exchange of similar properties.[137] Although the Supreme Court chose not to address this

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H. R. Rep. No. 704, 73d Cong., 2d Sess. 13 (1934).

131. *See* Weiss v. Stearn, 265 U.S. 242, 254 (1924).

132. *Id.* at 254.

133. The taxpayer in *Weiss* did terminate his interest in the old corporation. *See id.* at 251. Consequently, notwithstanding the similarities between the two corporations, the test adopted by the District Court in *Temple* would treat the *Weiss* transaction as a realization event.

134. *See* San Antonio Sav. Ass'n v. Commissioner, 887 F.2d 577, 589 (5th Cir. 1989) (citing Weiss v. Stearn, 265 U.S. 242, 254 (1924)). *See also* Sprouse v. Commissioner, 122 F.2d 973, 977 (9th Cir. 1941) (stock distribution is income only if it "effects a change in the proportionate interests of the stockholders"); Mitchell v. Commissioner, 45 B.T.A. 300, 304 (1941) (stock dividend does not constitute income "unless it (1) works a change in the corporate entity, or (2) gives the stockholder an interest different in character from that which his former holdings represented"). For the current statutory treatment of stock dividends, see I.R.C. § 305 (1991).

135. *See generally* I.R.C. §§ 351, 354, 361, 721, 1031, 1035, 1036 (1991) (various provisions in the Internal Revenue Code dealing with nonrecognition).

136. Brief for Petitioner at Part II.A.4 of the Argument, November 15, 1990, Cottage Sav. Ass'n v. Commissioner, 111 S. Ct. 1503 (1991) (No. 89-1965). *See also San Antonio*, 887 F.2d at 586 (taxpayer argued that the material difference standard undermines the Code's nonrecognition provisions); First Fed. Sav. & Loan Ass'n of Temple v. United States, 694 F. Supp. 230, 247-48 (W.D. Tex. 1988), *aff'd*, 887 F.2d 593 (5th Cir. 1989) (material difference test held inconsistent with the policy underlying the Code's nonrecognition provisions).

137. "Nonrecognition can also be envisioned as a refinement of the realization concept if property is exchanged for other property that, although different in some respects, is

issue in *Cottage Savings*, it was considered in other mortgage swap cases.[138]

For example, in *Temple*, the trial court refused to adopt the "material difference" standard proposed by the government.[139] Although the court held that the loans exchanged by Temple were not materially different,[140] it concluded that this did not limit realization of gain or loss.[141] Rather, the court observed that the Code anticipates that certain transactions lacking economic substance may result in the realization of gain or loss, and in that event nonrecognition provisions should be used to ensure that recognition is postponed.[142] The court relied on Treasury Regulation Section 1.1002-1(a) as authority for this position, noting that nonrecognition provisions were enacted because property received in an exchange is often "substantially a continuation of the old investment still unliquidated."[143]

The nonrecogniton provisions of the Code are not the product of Congressional efforts to ensure that a federal income tax is not imposed on those exchange transactions lacking economic substance, as suggested by *Temple*. Rather, these provisions were intended to provide taxpayers with nonrecognition treatment whenever an exchange of qualifying properties resulted in realized gain but yielded no cash profit.[144] The Treasury regulations do explain that nonrecognition treatment is available because differences between the properties exchanged "are more formal than substantial,"[145] but the legislative history of the nonrecognition provisions suggests that economic substance was at best a minor concern of lawmakers when these provisions were first included in the revenue

subject to substantially identical economic risks (e.g. § 1031)." 2 B. Bittker & L. Lokken, Federal Taxation of Income, Estates and Gifts 40.2, at 40-4 to 40-5 (2d ed. 1990).

138. *See supra* notes 126-28 and accompanying text.

139. *See* First Fed. Sav. & Loan Ass'n of Temple v. United States, 694 F. Supp. 230, 243-44 (W.D. Tex. 1988), *aff'd*, 887 F.2d 593 (5th Cir. 1989).

140. *Temple*, 694 F. Supp. at 245. The court held that the loans which qualified as "substantially identical" for purposes of Memorandum R-49 were economic substitutes for one another at the time of the transaction and therefore were not materially different. *See id.*

141. *Id.* at 243.

142. "All of these [nonrecognition] sections specifically provide for nonrecognition of realized gain or loss on the basis that the 'realized' gain or loss is the product of a sale or other disposition of property which lacks true economic substance." *Id.* at 247.

143. *Id.* at 246-47 (citing Treas. Reg. § 1.1002-1(c)(1951)). Apparently, the court was concerned that applying a substance over form test to realization would undermine the nonrecognition provisions. The Fifth Circuit in *San Antonio* responded:

> The realization requirement of material difference does not undercut these Code sections. It only provides a minimal standard that items exchanged may not be identical, fungible commodities. Such nonrecognition provisions of the wash sales rules (§ 1091) and the like exchange rules (§ 1031) are bright line rules dealing with specific circumstances not necessarily addressed by the material difference requirement of realization.

San Antonio Sav. Ass'n v. Commissioner, 887 F.2d 577, 586 (5th Cir. 1989).

144. *See* S. Rep. No. 275, 67th Cong., 1st Sess., 11-12 (1921).

145. *See* Treas. Reg. § 1.1002-1(c) (1957).

laws in 1921.[146] The concept of realization, in contrast, does focus on the substance of the transaction, as evidenced by the Supreme Court's decision in *Weiss*.[147] Thus, the reliance in *Temple* on nonrecognition provisions as the sole means of limiting recognition of gain and loss on fictitious transactions was misplaced.

A related argument raised by the taxpayer in *Cottage Savings* suggests that those transactions specifically excluded from the scope of nonrecognition provisions must result in realized and recognized gain or loss.[148] This argument is based on the fact that realization is a prerequisite to recognition.[149] With realization established in transactions normally qualifying for nonrecognition treatment, proponents of this position argue that Congressional action denying nonrecognition treatment evidences lawmakers' intent to treat the transaction as taxable.[150] Because denial of nonrecognition treatment has no effect on realization, gain or loss should be realized and recognized.

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146. Both the House and Senate reports accompanying the Revenue Act of 1921 indicate that these nonrecognition provisions were enacted in response to concerns over taxing exchanges that produced no cash profit, a result that inhibited business readjustment. *See* H.R. Rep. No. 350, 67th Cong., 1st Sess., 10 (1921); S. Rep. No. 275, 67th Cong., 1st Sess., 11-12 (1921). However, the last sentence of each of these reports lends some support to the position taken by Treasury in its regulations with respect to economic substance: "[t]he preceding amendments, if adopted, will, by removing a source of grave uncertainty, not only permit business to go forward with the readjustments required by existing conditions but will also considerably increase the revenue by *preventing taxpayers from taking colorable losses in wash sales and other fictitious exchanges*." H.R. Rep. No. 350, 67th Cong., 1st Sess., 10 (1921) (emphasis added). *See also supra* note 129.

147. *See* Weiss v. Stearn, 265 U.S. 242, 254 (1924). "Under *Weiss*, a formal change in ownership is not enough to trigger realization. In order for realization to occur, the party to an exchange must receive something really different than he previously had." *San Antonio*, 887 F.2d at 584.

148. *See* Brief for Petitioner at Part B of Argument Summary, Cottage Sav. Ass'n v. Commissioner, 111 S. Ct. 1503 (1991) (No. 89-1965). In its brief, Cottage Savings argued that the loss realized on its exchange of mortgage loans should be recognized because Congress specifically excluded debt instruments from the scope of the like kind exchange rules when it enacted the predecessor to § 1031(a)(2) in 1923. *See id.* (citing Rev. Act of 1923, Pub. L. No. 67-545, § 202(c), 42 Stat. 1560 (1923)).

149. Recognition provisions operate under the assumption that gain or loss has already been realized. *See* First Fed. Sav. & Loan Ass'n of Temple v. United States, 694 F. Supp. 230, 241 (W.D. Tex. 1988), *aff'd*, 887 F.2d 593 (5th Cir. 1989) (citing Treas. Reg. § 1.1002-1(a)); Century Elec. Co. v. Commissioner, 192 F.2d 155, 159 (8th Cir. 1951), *cert. denied*, 342 U.S. 954 (1952); 2 B. Bittker & L. Lokken, Federal Taxation of Income, Estates and Gifts 44.1.1, at 44-2 (2d ed. 1990).

150. *See* Brief for Petitioner at Part II.A.2 of the Argument, Cottage Sav. Ass'n v. Commissioner, 111 S. Ct. 1503 (1991) (No. 89-1965). Although the addition of current § 1031(a)(2) in 1923 had the effect of characterizing exchanges involving inventory, stocks and bonds, notes, and other readily marketable assets as taxable events, the legislative history of the Revenue Act of 1923 suggests that the amendment was intended to prevent taxpayers from deferring recognition of gain in situations involving the exchange of assets having a readily ascertainable value for similar assets and cash. *See* H.R. Rep. No. 1432, 67th Cong., 4th Sess., 1-2 (1923) (which includes the text of a January 13, 1923 letter to William R. Green, acting Chairman of the Committee on Ways and Means, from Treasury Secretary A.W. Mellon, explaining the purpose of the amendment to the like-kind exchange rules).

This position, however, fails to recognize that the scope of these nonrecognition provisions is different than that of the "materially different" limitation on realization. There is some overlap, to be sure, but the like kind exchange rules, for example, deal with a broader range of exchanges than those subject to the "materially different" standard.[151] Thus, the realization requirement is satisfied whenever an exchange of properties qualifies for nonrecognition treatment under Section 1031(a). Conversely, no realized gain or loss results from such a transaction if, because of the similarities of the properties involved, the transaction is treated as a substitution of identical properties failing to qualify as an "exchange" or "disposition."[152] The "materially different" limitation on realization must therefore be viewed not as another nonrecognition provision, but as a threshold question that considers whether the transaction should be respected as an "exchange" or "other disposition" for tax purposes.

3. The Treasury Regulation as Authority

Many of the taxpayers in the mortgage swap cases also argued that, technically, the Court's reliance on Treasury's interpretation of the realization requirement was improper because a literal reading of the regulation's language does not produce the "materially different" test subsequently adopted by the *Cottage Savings* Court.[153] Although the

151. For example, when a taxpayer exchanges a farm used in his business for an undeveloped city lot he intends to hold for investment, gain or loss is realized on the exchange because the two properties are "materially different," but no gain or loss is recognized under I.R.C. § 1031(a) since the properties qualify under the like kind standard. *See* Treas. Reg. § 1.1031(a)-1(b) (as amended in 1967).

152. Both I.R.C. §§ 1031 and 1036 apply only to transactions qualifying as "exchanges." *See* I.R.C. §§ 1031(a)(1), 1036(a). The taxpayer in *Cottage Savings* offered a related argument suggesting that Congress intended for mortgage swap transactions to result in realization and recognition of gain and loss because they are specifically excluded from the scope of § 1031. *See* Brief for Petitioner at Part B of Argument Summary, Cottage Sav. Ass'n v. Commissioner, 111 S. Ct. 1503 (1991) (No. 89-1965) (citing I.R.C. § 1031(a)(2)(1991)). According to the taxpayer, the fact that the like kind exchange rules initially allowed taxpayers to exclude gain on items now excluded under § 1031(a)(2) suggested that, when Congress specifically excluded these items from the scope of § 1031, it intended for gain or loss from the exchange of these items to be recognized. *See id.* The taxpayer supported its position by noting that the legislative history of the Revenue Act of 1934 confirmed the tax treatment due exchanges of loans: "profit or loss is recognized in the case of exchanges of notes or securities, which are essentially like money." H.R. Rep. No. 704, 73d Cong., 2d Sess. 13 (1934). According to the taxpayer, the fact that Congress did not then, and has not since, changed the limitation on these rules indicates that it intended for gain or loss from the exchange of those items to be recognized. *See* Brief for Petitioner at Part B of Argument Summary, Cottage Sav. Ass'n v. Commissioner, 111 S. Ct. 1503 (1991) (No. 89-1965).

This conclusion is correct, provided the gain or loss has been realized. Thus, the nonrecognition provisions do not establish that realization occurs as a result of every exchange. The concept of realization does do so, however, with respect to every transaction that qualifies as an exchange for tax purposes.

153. *See, e.g.*, Brief for Petitioner at Part II.A.1 of the Argument, Cottage Sav. Ass'n v. Commissioner, 111 S. Ct. 1503 (1991) (No. 89-1965).

regulation does not expressly limit realization to transactions involving the receipt of cash or materially different property,[154] it does imply that such a limitation exists.[155] Thus, any suggestion that the scope of Treasury's "materially different" limitation on realization should be evaluated *solely* by reference to the language used in the regulation should be dismissed as inconsistent with the spirit of the limitation.

A related argument raised by opponents of the "materially different" standard suggested that judicial reliance on the regulation was improper because the regulation was promulgated pursuant to Section 1001, a statutory provision that is purely computational and that therefore does not support an interpretive regulation seeking to limit the scope of realization.[156] Both the language of Section 1001(a)[157] and its legislative history[158] establish that it is indeed a computational provision.[159] Proponents of this position argued that Treasury's attempt to define the parameters of realization in a regulation promulgated pursuant to a statutory provision dealing solely with the computation of realized gain or loss should be held invalid.[160] Tax Court Judge Cohen subscribed to this argument in her concurring opinion in *Cottage Savings*,[161] as did the Sixth Circuit when it considered the case on appeal.[162]

These arguments, however, failed to prevent the Supreme Court from adopting Treasury's "materially different" test.[163] Although the Court's

154. Cottage Sav. Ass'n v. Commissioner, 90 T.C. 372, 390-91 (1988), *rev'd*, 890 F.2d 848 (6th Cir. 1989), *rev'd and remanded*, 111 S. Ct. 1503 (1991).

155. *See, e.g.*, Emery v. Commissioner, 166 F.2d 27 (2d Cir. 1948)(holding that regulation did not apply to to an exchange of municipal refunding bonds for old bonds because statute does not apply to municipal corporations).

156. *See Cottage Savings*, 90 T.C. at 403 (Cohen, J., concurring).

157. *See supra* note 22.

158. The legislative history of § 202(b) of the Revenue Act of 1924, the predecessor of § 1001(a), provides that it was intended "to show clearly the method of determining the amount of gain or loss from the sale or other disposition of property [and] merely embodies in the law the present construction by the Department and the courts of the existing law." S. Rep. No. 398, 68th Cong., 1st Sess. 13 (1924), *reprinted in* 1939-1 (Part 2) C.B. 266, 275.

159. *See also* Treas. Reg. § 1.61-6(a) (1957), (providing that gain realized on the sale or exchange of property is included in gross income). According to this regulation, rules for computing the gain are included in § 1001. *See id.*

160. *See* Brief for Petitioner at Part II.A.1 of the Argument, Cottage Sav. Ass'n v. Commissioner, 111 S. Ct. 1503 (1991) (No. 89-1965).

161. *See* Cottage Sav. Ass'n v. Commissioner, 90 T.C. 372, 403 (1988) (Cohen, J., concurring), *rev'd*, 890 F.2d 848 (6th Cir. 1989), *rev'd and remanded*, 111 S. Ct. 1503 (1991). Judge Cohen observed that earlier versions of Treas Reg. § 1.1001-1(a) conditioned realization on an exchange involving materially different properties, but the current provision does not. *See id.* (citing n.13 of the majority's opinion). Noting that the controlling statute, § 1001(a), is a computation provision, she concluded that the underlying regulation must also be computational and therefore does not speak to realization. *See id.* On appeal, the Sixth Circuit agreed with Judge Cohen and refused to support a "materially different" limitation on realization. *See Cottage Savings*, 890 F.2d at 852.

162. *See id.*

163. *See* 111 S. Ct. at 1508.

position on these issues is unknown,[164] the explanation offered by the Fifth Circuit in *San Antonio* may reflect the Court's view on these issues:

> It is true that Treas. Reg. § 1.1001-1(a) does not in its terms create the requirement of material difference. The concept of realization is what creates the material difference requirement. . . . Because the material difference requirement is already inherent in the concept of realization, however, the "differing materially" language in Treas. Reg. § 1.1001-1(a) may be read as a *reference* to an established requirement rather than as establishing the requirement.[165]

Thus, some limitation on realization based on the nature of the properties involved in the exchange is appropriate. What remains is to determine whether the Supreme Court's method of limitation, a test based on a comparison of the legal rights relinquished and received in an exchange, furthers the goal of distinguishing between true exchanges and those that are in substance substitutions of identical assets deserving no recognition as exchanges for tax purposes.

IV. APPLYING THE SUPREME COURT'S "LEGAL ENTITLEMENTS" TEST

A. *Evaluating the Legal Entitlements Theory*

The Supreme Court held in *Cottage Savings* that an evaluation of the "legal entitlements" associated with properties involved in an exchange is necessary to determine whether such properties satisfy the "materially different" standard found in the Treasury Regulations.[166] Relying on its landmark realization decisions, the Court concluded that "*Phellis*, *Marr* and *Weiss* stand for the principle that properties are 'different' in the sense that is 'material' to the Internal Revenue Code so long as their respective possessors enjoy legal entitlements that are different in kind or extent."[167]

Although the Court offered no definition of "legal entitlements," it did offer examples to assist in determining when these legal entitlements differ in kind or extent:

> [s]eparate groups of stock are not materially different if they confer 'the same proportional interest of the same character in the same corporation.' However, they *are* materially different if they are issued by different corporations, or if they confer 'differen[t] rights and powers'

164. The *Cottage Savings* Court failed to mention these issues in its opinion. *See id.*

165. San Antonio Sav. Ass'n v. Commissioner, 887 F.2d 577, 586 (5th Cir. 1989)(emphasis in original).

166. *See* Cottage Sav. Ass'n v. Commissioner, 111 S. Ct. 1503, 1511 (1991). *See also supra* notes 45-47 and accompanying text. *Cf.* Allen v. Commissioner, 49 F.2d 716, 719 (2d Cir. 1931) ("It may be that the transaction was not an 'exchange' . . . though it was certainly not very different: but the question whether a profit ensues depends not so much upon whether one chattel is exchanged for another as upon what are the rights of the taxpayer before and after the transaction under consideration.").

167. *Cottage Savings*, 111 S. Ct. at 1510.

> in the same corporation. No more demanding a standard than this is necessary in order to satisfy the administrative purposes underlying the realization requirement in § 1001(a).[168]

The Court's description of the legal entitlements test suggests that an exchange transaction will result in realized gain or loss unless the properties involved are "the same." This conclusion is buttressed by language later in the Court's opinion summarizing the new test: "For, as long as the property entitlements are not *identical*, their exchange will allow both the commissioner and the transacting taxpayer easily to fix the appreciated or depreciated values of the property relative to their tax bases."[169] Thus, the Court's endorsement of Treasury's "materially different" standard amounts to an affirmation of the holding in *Weiss* that a substitution of identical properties will not be treated as a realization event.[170] Materiality apparently plays no role in the determination, based on the examples provided by the *Cottage Savings* Court.

The Court may have focused on "legal entitlements" in *Cottage Savings* as a means of applying its decisions in *Weiss* and *Marr* to other property exchange cases. As noted by the *Marr* Court during its discussion of the result in *Weiss*, "[t]echnically there was a new entity; but the corporate identity was deemed to have been substantially maintained because the new corporation was organized under the laws of the same State, with presumably the same powers as the old."[171] Thus, the taxpayer in *Weiss* received stock in a different corporation, but because both corporations were organized in the same state, the transaction did not leave the taxpayer with legal entitlements different from those held prior to the transaction.[172] The same cannot be said for the taxpayer in *Marr*, for although the transaction resulted in no change in the identity of the business, the "legal entitlements" associated with the stock received in the exchange were different from those given up because the corporations were organized in different states.[173] Thus, the *Cottage Savings* Court's focus on "legal entitlements" allowed it to justify and rely on its earlier decisions in *Weiss* and *Marr* in developing a test for applying the "materially different" standard.[174]

By adopting an approach that focuses on the legal rights associated with the properties exchanged, the Court rejected the government's "eco-

168. *Id.* (citations omitted).
169. *Id.* (emphasis added).
170. *See* Weiss v. Stearn, 265 U.S. 242 (1924).
171. Marr v. United States, 268 U.S. 536, 541 (1925). *See supra* note 100.
172. *See Weiss*, 265 U.S. at 253.
173. *See Marr*, 268 U.S. at 541.
174. The *Cottage Savings* Court also cited *Phellis* in support of this conclusion. *See* Cottage Sav. Ass'n v. Commissioner, 111 S. Ct. 1503, 1510 (1991). Although the *Phellis* Court did evaluate the interest received by a taxpayer using a "materially different" standard, the case did not involve an exchange since the taxpayer did not relinquish the stock previously held. *See* United States v. Phellis, 257 U.S. 156 (1921). Consequently, *Phellis* does not provide direct support for the test developed by the Court in *Cottage Savings*.

nomic substitute" theory.[175] The government argued that "differences between properties are material for purposes of the Code only when it can be said that the parties, the relevant market (in this case the secondary mortgage market), and the relevant regulatory body (in this case the FHLBB) would consider them material."[176] The Court rejected this approach, concluding that it was inconsistent with supporting case law, established nonrecognition provisions, and the underlying purpose of the realization requirement.[177]

B. *Applying the Court's "Legal Entitlements" Test*

As with any test, the "materially different" standard must provide reasonable and predictable results in order to justify its continued use. Presumably, the *Cottage Savings* Court focused on the legal entitlements associated with the properties exchanged as a means of ensuring that the "materially different" test would provide results consistent with those obtained in *Phellis, Weiss,* and *Marr.*[178] Use of the "legal entitlements" test produced justifiable results in *Cottage Savings* and *Centennial,* and appears to lend support to tax treatment currently afforded other exchange transactions.

For example, Section 1036 of the Code provides that the exchange of common stock for common stock of the same corporation does not result in the recognition of gain or loss.[179] A similar result is obtained in exchanges involving preferred stock of the same corporation.[180] Although the presence of this provision suggests that realization has occurred,[181] this type of transaction does not constitute an exchange triggering realization because the recipient is not left with legal rights different from those relinquished.[182] Consequently, the Supreme Court's "legal entitle-

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175. *See Cottage Savings,* 111 S. Ct. at 1510-11.

176. *Id.* at 1510.

177. *See id.* at 1510-11. The Court concluded that the purpose of the nonrecognition provision—to provide a measure of administrative convenience—was not furthered by adoption of the government's complex "economic substitute" approach. *See id.* In *San Antonio,* the Fifth Circuit concluded that the government's "economic benefit" approach would often produce unjustifiable results. *See* San Antonio Sav. Ass'n v. Commissioner, 887 F.2d 577, 590 (5th Cir. 1989). The court illustrated its conclusion with the following example:

> [I]f two taxpayers exchanged two bonds of different corporate entities engaged in entirely different businesses, but which have the same rating by Moody's, the same interest rate, the same cash flow, the same maturity and the same value in the capital market then no change in their "economic status" would have occurred. The transaction, would, nevertheless be real, and the taxpayer should not be able to postpone losses and gains while switching bonds or other assets merely because they are "economic substitutes."

Id.

178. *See supra* notes 167-71 and accompanying text.

179. I.R.C. § 1036(a) (1991).

180. *See id.*

181. *See supra* note 149.

182. This conclusion is consistent with that of the Supreme Court in *Weiss*: the ex-

ments" test provides results in this area consistent with those currently available from nonrecognition provisions included in the Code.[183]

Results obtained through an application of the "legal entitlements" test also are consistent with those available under current law that deal with the exchange of partnership interests. The exchange of a general partnership interest for a limited partnership interest (or a limited interest for a general interest) in the same partnership provides the recipient with legal entitlements far different than those relinquished.[184] Consequently, this type of transaction should be characterized as an exchange of materially different property interests that results in realized gain or loss.

The current position of the Internal Revenue Service on the exchange of partnership interests appears to acknowledge that the differences between a general and limited partnership interest justify characterization of the transaction as a realization event. In Revenue Ruling 84-52, the Service ruled that the receipt of a limited partnership interest by an existing partner in exchange for that partner's general partnership interest does not result in the recognition of gain or loss.[185] By relying on a nonrecognition provision, Section 721 of the Internal Revenue Code,[186] the Service implicitly acknowledged that the transaction triggers realized gain or loss.[187] Thus, application of the "materially different" test provides results that are consistent with those available under current law.

Although the Court's focus on "legal entitlements" appears to produce justifiable outcomes in a number of property exchange transactions, endorsement of the test may yield unexpected results in other types of transactions. Consider the following examples.

1. Bond Refinancing Transactions

The courts have held that in most cases, the receipt of bonds issued to replace outstanding bonds will result in the realization of gain or loss.

change of stock for stock in what is, in substance, the same corporation, is not a realization event. *See* Weiss v. Stearn, 265 U.S. 242 (1924).

183. Application of the "legal entitlements" test to other stock-for-stock exchange transactions confirms that most are properly treated as realization events. For example, an exchange of common stock for preferred stock leaves the recipient with legal rights different than those enjoyed prior to the exchange. Consequently, this type of exchange is properly characterized as a realization event, a conclusion implicitly acknowledged in I.R.C. § 368(a)(1)(E), which characterizes this type of exchange as a tax-free reorganization. *See* Rev. Rul. 77-238, 1977-2 C.B. 115.

184. For example, a general partner is entitled to participate in management decisions affecting the business of the partnership, while a limited partner has no such entitlement. *Compare* Unif. Part. Act § 18(e), 6 U.L.A. 213 (1969) *with* Rev. Unif. Ltd. Part. Act § 303(b) (1976).

185. *See* Rev. Rul. 84-52, 1984-1 C.B. 157-58.

186. I.R.C. § 721(a) (1991) provides that no gain or loss shall be recognized by a partner or partnership on the contribution of property to the partnership in exchange for an interest in the partnership. An analysis of the Service's reliance on § 721(a) in this context is beyond the scope of this article.

187. *See* Rev. Rul. 84-52, 1984-1 C.B., 157-58.

Thus, in *Emery v. Commissioner*,[188] the Second Circuit held that gain was realized on the exchange of City of Philadelphia bonds for newly-issued refunding bonds issued by the City.[189] Noting that the interest rate, maturity and call dates, and fair market values of the bonds differed, the Court concluded that the bonds exchanged were materially different, thus satisfying the test announced in *Weiss v. Stearn* and embodied in Treasury Regulation Section 29.111-1.[190]

The Board of Tax Appeals relied on the same authority to reach a different result in *Motor Products Corp. v. Commissioner*.[191] In *Motor Products*, the taxpayer exchanged City of Detroit bonds then in default for newly-issued refunding bonds.[192] With the exception of an extended maturity date, the terms of the refunding bonds were identical to those of the original bonds.[193] Relying on *Weiss*, the Board held that the bonds received were substituted for those previously held, given the similarity of the two bond issues.[194] While conceding that the city retained the right to call the bonds prior to maturity, the Board concluded that the difference in maturity dates was, as a practical matter, irrelevant.[195] The Board held that the taxpayer realized no gain or loss on the receipt of the new bonds.[196]

Use of the Supreme Court's "legal entitlements" test produces results consistent with those obtained by the courts in these refinancing cases. The bonds exchanged by the taxpayer in *Emery* were "materially different" because bonds having different terms necessarily provide the holder with different legal rights.[197] In contrast, the transaction described in

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188. 166 F.2d 27 (2d Cir. 1948).

189. *See id.* at 29.

190. *See id. Accord* Girard Trust Co. v. United States, 166 F.2d 773 (3d Cir. 1948). *See also* Watson v. Commissioner, 8 T.C. 569, 581-82 (1947) (differences in terms of debt certificates held sufficient to justify exchange treatment); Rev. Rul. 73-558, 1973-2 C.B. 298 (exchange of mortgage loan pools bearing different rates of interest treated as a taxable exchange).

191. 47 B.T.A. 983, 997-99 (1942), *acq.*, 1946-1 C.B. 3. *See also* City Bank Farmers Trust Co. v. Hoey, 52 F. Supp. 665, 666 (S.D.N.Y. 1942) (reaching an identical result with respect to a similar exchange of City of Detroit bonds).

192. *See Motor Products*, 47 B.T.A. at 992.

193. *See id.* at 997.

194. *See id.* at 998. The Board offered the following explanation:

> The city assumed no additional obligation under the refunding agreement or upon the refunding bonds, series A, since upon the consummation of the refunding agreement through the issuance of such series A bonds there existed the same debtor, the same principal amount of indebtedness, the same rate of interest thereon, the same provision for a sinking fund, and the same creditors. Certainly, from the standpoint of the city of Detroit the essence of the 1934 transaction was an exchange constituting merely a substitution of the evidence of the same continuing debt.

Id. at 996.

195. *See* Motor Prods. Corp. v. Commissioner, 47 B.T.A. 983, 997 (1942).

196. *See id.* The Service reached the same conclusion when it considered similar facts in Rev. Rul. 54, 1954-1 C.B. 204.

197. For example, a difference in interest rates provides the holder with a legal entitlement to more (or less) interest income. Similarly, a change in maturity dates entitles the

Motor Products did not involve materially different properties because the terms of the obligations exchanged were in substance identical and therefore provided the recipient with no new legal rights.[198] These two cases illustrate that changes in the terms of an obligation made during the refinancing process will provide the recipient with different legal rights which, under the legal entitlements test, will justify treatment of the transaction as a taxable exchange.[199]

Consider, however, the position taken by the Internal Revenue Service in Revenue Ruling 73-160.[200] In this ruling, the Service concluded that the voluntary subordination of a portion of an outstanding obligation by a major noteholder, accompanied by an extension of the maturity date, did not constitute a taxable event.[201] The decision, which was based on an application of the "materially different" standard,[202] suggests that the additional security offered by a subordination agreement does not leave noteholders with property different enough to justify a departure from the result reached in *Motor Products*.

Revenue Ruling 73-160 provides a different result than that obtained through a comparison of the legal entitlements enjoyed by noteholders before and after the transaction. As a result of the change in terms described in the ruling, noteholders are entitled to receive interest over a longer period of time—a legal right not diminished by the presence of an unlimited call provision such as that found in *Motor Products*.[203] In addition, the subordination agreement ensures that noteholders will be repaid in full before any payments are made to a major creditor. Given these new legal entitlements, the notes received in the transaction described in Revenue Ruling 73-160 are materially different and therefore are the subject of a taxable exchange.

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holder to interest income over a longer (or shorter) period of time. *But cf. Motor Products*, 47 B.T.A. 983, 997 (1942) (difference in maturity dates irrelevant where the principal terms of the refunding bonds were identical to those of the original bonds), discussed *supra* notes 191-96 and accompanying text.

198. See *supra* note 197.

199. *See generally* Winterer, *"Reissuance" and Deemed Exchanges Generally*, 37 Tax Lawyer 509 (1983). *But cf.* Newberry v. Commissioner, 4 T.C.M. (CCH) 576, 581 (1945) (exchange of bonds bearing different interest rates held not a taxable event). Given the legal entitlement to a different rate of interest, the Supreme Court's test would change the result in this case.

200. 1973-1 C.B. 365. In Rev. Rul. 73-160, the debtor corporation proposed that the maturity date of its outstanding notes be extended by agreement with existing noteholders. The corporation asked noteholders to deliver outstanding notes to an intermediary for the purpose of attaching a copy of the agreement and additional interest coupons (bearing interest at the rate originally specified in the notes). The intermediary then returned the notes to their respective owners. *See id.*

201. *See id.*

202. The IRS observed that "[w]here the changes are so material as to amount virtually to the issuance of a new security, the same income tax consequences should follow as if the new security were actually issued." *Id.*

203. *See Motor Products*, 47 B.T.A. 983, 997 (1942). *See also supra* note 195 and accompanying text.

2. Exercising Conversion Rights

Conversion rights granted to the holder of corporate debt securities are exercised by exchanging debt securities for that number of shares of stock specified in the conversion provision of the debt instrument. This exchange of debt for stock necessarily involves different property interests; the legal entitlements enjoyed by a bondholder are considerably different than those attributable to the interest of a stockholder.[204] Consequently, the "materially different" test endorsed by the Supreme Court in *Cottage Savings* would characterize an exchange of debt for stock as a realization event.

The Treasury Department established its position on the tax consequences associated with the exercise of conversion rights with the following policy, which was adopted in regulations promulgated under the Revenue Act of 1918:

> Where the owner of a bond exercises the right, provided for in the bond, of converting the bond into stock in the obligor corporation, such transaction does not result in a realization of profit or loss, the transaction not being closed for purposes of income taxation until such stock is sold.[205]

Although this language never again appeared in the regulations, Treasury renewed the policy in a series of pronouncements[206] and later established its position through the issuance of Revenue Ruling 72-265.[207] Clearly, the tax treatment endorsed by the government in this ruling produces results far different from those obtained by applying the "materially different" standard endorsed by the Supreme Court in *Cottage Savings.*

The Internal Revenue Service takes a similar position with respect to debt-for-debt exchanges occasioned by the exercise of conversion rights. In Revenue Ruling 57-535,[208] the Service considered the question whether the receipt of 1.5% five-year Treasury Notes, pursuant to the exercise of a conversion provision included in the issuance terms of nonmarketable 2.75% bonds that were relinquished in the exchange, constituted a realization event.[209] Apparently relying on the fact that the conversion rights exercised were granted when the bonds were issued,[210]

204. For example, when a corporation liquidates or files for protection from creditors under bankruptcy laws, a bondholder will be repaid in full before any payments are made to stockholders with respect to their equity investment in the corporation. *See Sinking Fund Cases*, 99 U.S. 700, 722 (1878).

205. Treas. Reg. No. 45, Art. 1563, 21 Treas. Dec. Int. Rev. 170, 393 (1919).

206. *See* Mimeograph 3156, C.B. II-2, 24 (1923) and Gen. Couns. Mem. 18,436, 1937-1 C.B. 101, both of which confirmed that Treasury would continue to treat the exercise of conversion rights as a nontaxable transaction notwithstanding the omission of its policy on this question from the regulations.

207. 1972-1 C.B. 222.

208. 1957-2 C.B. 513.

209. *See id.* at 514.

210. The IRS used the same argument to justify tax-free treatment of debt-for-stock

the Service characterized the debt-for-debt exchange as a "transformation" rather than a disposition. Thus, no gain or loss was realized.[211] Given changes in both the interest rate[212] and the nature of the rights held by the taxpayer (conversion from nonmarketable to marketable interest) that follow from the exchange described in the ruling, the Supreme Court's "legal entitlements" test would treat this transaction as an exchange of materially different properties resulting in realized gain or loss.

3. Partitioning Interests in Property

When title to property is held jointly by two or more persons, each owns an undivided interest in the entire property and each interest is subject to certain rights held by the other co-owners.[213] Consequently, the exchange of an interest in jointly held property for a different interest in the same property may be considered a realization event under Treasury's "materially different" standard if the transaction results in a change in each co-owner's legal rights with respect to the property.

Currently, however, certain transactions involving jointly owned property are not treated as exchanges for federal income tax purposes. For example, joint owners who buy out the interest of one owner by repurchasing the jointly owned property at a partition sale realize no gain or loss on the sale.[214] Similarly, a sale and repurchase of property at public auction by current co-owners for the purpose of perfecting title is not a taxable event, provided the proceeds of the sale are distributed to the co-owners in proportion to their respective interests.[215] The result in each of these two scenarios is consistent with that obtained by application of Treasury's "materially different" standard: the co-owners are left with legal entitlements identical to those they enjoyed prior to the transaction, and therefore they have not received property interests materially different from those relinquished.[216]

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exchanges resulting from the exercise of conversion rights. *See supra* notes 205-07 and accompanying text.

211. *See* 1957-2 C.B. at 516. The Service concluded that "[i]n substance and effect, he continued to own the same property, its form being changed pursuant to a right embodied in it when he acquired it." *Id.*

212. A change in the interest rate was enough to justify characterization of a debt-for-debt exchange as a realization event in Emery v. Commissioner, 166 F.2d 27, 29 (2d Cir. 1948). *See supra* notes 188-90 and accompanying text.

213. *See generally* R. Cunningham, W. Stoebuck & D. Whitman, The Law of Property §§ 5.1-5.16 (1984)(discussing partition and property rights of co-tenants).

214. *See* Rev. Rul. 55-77, 1955-1 C.B. 339.

215. *See* Rev. Rul. 55-179, 1955-1 C.B. 340.

216. Although the co-owners described in the first scenario are left with a larger undivided interest in the property as a result of the transaction, their legal rights with respect to the property are identical. In the second scenario, the rights of each co-owner are enhanced by the public sale in the sense that the action results in perfected title, but in measuring the change in legal rights against a property owner's expectation of perfect title, such an action merely places the owner in the position originally bargained for and therefore should not be treated as an enhancement of legal rights.

The conversion of property held in joint tenancy to a tenancy in common, either by agreement or by an action of partition under state law, for the purpose of eliminating survivorship rights, also is not a taxable event under current law.[217] Yet, the elimination of survivorship rights effects a significant change in the legal rights of joint owners of property,[218] and based on the Supreme Court's interpretation of the materially different requirement in *Cottage Savings*, this change in "legal entitlements" would justify characterization of this transaction as a realization event. Presumably, this result was not contemplated by the Court in *Cottage Savings* when it developed the "legal entitlements" test.

Finally, consider a partition of property by co-owners that vests in each owner a fee simple interest in a portion of the parcel previously held in co-ownership. The legal rights enjoyed by the owner of a fee simple interest in property are considerably different than those of a co-owner of property.[219] Based on the reasoning of *Cottage Savings*, this difference in legal entitlements triggers realization because the interests exchanged are deemed "materially different."[220] Two rulings issued by the Internal Revenue Service support this conclusion by holding that nonrecognition

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217. *See* Rev. Rul. 56-437, 1956-2 C.B. 507.

218. When property is held in joint tenancy, the death of one tenant results in a transfer of a complete interest in the property to the survivor. R. Cunningham, W. Stoebuck & D. Whitman, The Law of Property § 5.3, at 207 (1984). This legal right is relinquished when survivorship rights are eliminated through a conversion of the joint tenancy to a tenancy in common because, on the death of a co-owner of property held as a tenancy in common, the property interest passes to the cotenant's heirs by will or intestate succession. *See id.* § 5.2, at 198-99. Thus, the elimination of survivorship rights effects a significant change in the legal entitlements previously enjoyed by the surviving co-tenant.

219. The owner of a fee simple interest in property enjoys rights that are subject to no other person. *See id.* § 2.2, at 33. In contrast, the owner of an interest in property held in joint tenancy or tenancy in common has an undivided interest in the entire property that is subject to the rights of the other cotenants, *see id.* §§ 5.2-5.3, at 196-207, and is subject to fiduciary standards imposed for the benefit of the other cotenants. *See id.* § 5.10, at 225.

220. Consider, however, the tax treatment afforded divisions of community property between spouses. Prior to the enactment of I.R.C. § 1041 in 1984, an equal division of community property between spouses was not treated as a taxable event. *See* Carrieres v. Commissioner, 64 T.C. 959, 964 (1975). Similarly, an unequal division of community property which left each spouse with property having a value approximately equal to one-half of the value of the community property was treated as nontaxable. *See, e.g.*, Wren v. Commissioner, 24 T.C.M. (CCH) 290, 293 (1965) (where parties divide community property equally, such an agreement is not taxable); Walz v. Commissioner, 32 B.T.A. 718, 719 (1935) (same). *Cf.* Rev. Rul. 81-292, 1981-2 C.B. 158 (approximately equal division of the total value of jointly owned property in a noncommunity property state is a nontaxable division of property). The interests exchanged in these transactions would be classified as "materially different" based on the legal entitlements theory used by the Supreme Court in *Cottage Savings*, given the difference in legal rights enjoyed by the spouses after the division of property. Although application of the "materially different" standard to exchanges of property between spouses would have changed the result reached in these early cases, the result is now based on legislation codified as I.R.C. § 1041: no gain or loss is recognized on the transfer of property by an individual to a spouse, or to a former spouse if the transfer is incident to divorce. I.R.C. § 1041(a) (1991).

treatment is available under Section 1031 of the Code to parties involved in similar exchange transactions.[221]

4. Exchange of Interest in Trust for Trust Assets

Until recently, the tax consequences associated with the exchange of an interest in an investment trust for assets of the trust was well settled. Case law established that the equitable interest in trust assets held by a certificate holder was sufficiently different from legal ownership of the underlying assets to justify treatment of the transaction as a realization event.[222] The Internal Revenue Service agreed with this conclusion in a ruling involving similar facts.[223]

Recently, the Service changed its position on the tax treatment of these transactions. In Revenue Ruling 90-7,[224] the Service held that the owner of an interest in an investment trust is treated as the owner of an undivided interest in the trust's assets.[225] As an owner of trust assets, a certificate holder realizes no gain or loss on an exchange of trust certificates for trust assets, according to the ruling, because "the exchange effect[s] no material difference in [the taxpayer's] position."[226]

The position taken by the Service in Revenue Ruling 90-7 is inconsis-

221. *See* Rev. Rul. 73-476, 1973-2 C.B. 301; Rev. Rul. 79-44, 1979-1 C.B. 265, 266 discussed *supra* note 226.

222. *See* Commissioner v. Tew, 108 F.2d 570, 571 (6th Cir. 1940); Du Bois Young v. Commissioner, 34 B.T.A. 648, 651-52 (1936).

223. *See* Rev. Rul. 68-633, 1968-2 C.B. 329, 330.

224. Rev. Rul. 90-7, 1990-1 C.B. 153.

225. *See id.* at 154. Relying on Rev. Rul. 84-10, 1984-1 C.B. 155 (mortgage pool certificate holder is treated as owner of undivided interest in pool under I.R.C. § 671), the Service held that, for tax purposes, an investment trust certificate holder is treated as the owner of the assets of the trust. *See* Rev. Rul. 90-7, 1990-1 C.B. at 154. *Cf.* Rev. Rul. 85-13, 1985-1 C.B. 184 (grantor treated as the owner of a trust under I.R.C. § 671 is considered the owner of the trust assets for federal income tax purposes).

Commentators and the courts have criticized the IRS for its use of the Grantor Trust Rules (I.R.C. §§ 671-679) in this manner. *See generally* Ascher, *When to Ignore Grantor Trusts: The Precedents, a Proposal, and a Prediction*, 41 Tax L. Rev. 252 (1986) (concluding that I.R.S. decisions on whether to ignore or respect the separate existence of grantor trusts have been inconsistent).

226. 1990-1 C.B. at 154. This is similar to the conclusion reached by the Service with respect to the severance of a property interest held by co-owners, each of whom owns an undivided interest in the entire property prior to severance. *See supra* note 217 and accompanying text.

Both rulings cited by the Service involved the exchange of trust certificates for an interest in each of the trust assets. If such a transaction involved the exchange of trust certificates for one of a number of trust assets, it seems clear that the resulting change in legal rights would trigger realization. Support for this conclusion is found in Rev. Rul. 73-476, 1973-2 C.B. 301. In that ruling, the Service held that a partition of three parcels of real property between three co-owners qualified for nonrecognition treatment under I.R.C. § 1031(a). Implicit in the Service's conclusion is the fact that the exchange of an undivided interest in three properties for a complete interest in one property constitutes a realization event. *See supra* note 149; *see also* Rev. Rul. 79-44, 1979-1 C.B. 265, 266 (exchange of undivided interest in two parcels of land by taxpayer for complete interest in one of the two parcels held within the scope of I.R.C. § 1031(a)).

tent with the result obtained by using Treasury's "materially different" standard. The exchange of trust certificates for trust assets is an exchange of materially different interests in property because it gives the owner different "legal entitlements."[227] Thus, this transaction involves materially different property which, under Treasury Regulation Section 1.1001-1(a), results in realized gain or loss.

CONCLUSION

The Supreme Court's endorsement of the Treasury Department's "materially different" standard in *Cottage Savings* represents its attempt to provide a framework within which the tax treatment of property exchanges may be evaluated. Consistent with the Court's decisions in three landmark realization cases, the test endorsed by the Court treats any exchange of materially different properties as a taxable event resulting in realized gain or loss.[228]

The "legal entitlements" test developed by the *Cottage Savings* Court brings some measure of predictability to an uncertain and infrequently used standard of federal taxation. By comparing the legal rights held by taxpayers before and after an exchange, the Court identified those characteristics of a property transaction that most accurately establish whether the transaction is in substance an exchange of different interests in property.[229]

With the Court's development of this test, however, comes inevitable uncertainty. Although application of the Court's "legal entitlements" test to Treasury's "materially different" standard provides justifiable and predictable results in many cases, it actually alters the current tax treatment of other types of transactions. A partition of joint property interests,[230] the receipt of stock for convertible debt securities,[231] and the exchange of investment trust certificates for trust assets[232] are examples of previously tax-free transactions that become realization events by reason of the approach announced by the Court in *Cottage Savings.* No doubt other transactions that presently enjoy tax-free treatment will be similarly affected. Thus, it is likely that the sudden potential for change that follows from the *Cottage Savings* decision will generate disputes and litigation in the absence of action by lawmakers or the Treasury Department to clarify the tax treatment of these and other exchange transactions.

227. For example, the legal rights of a certificate holder do not include the right to sell trust assets, a right enjoyed by the certificate holder after exchanging certificates for trust assets.
228. *See supra* notes 60-101 and accompanying text.
229. *See supra* note 118.
230. *See supra* notes 213-21 and accompanying text.
231. *See supra* notes 204-12 and accompanying text.
232. *See supra* notes 222-27 and accompanying text.