1989

Planning Considerations for Like-Kind Exchanges Involving Partnerships

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PLANNING CONSIDERATIONS FOR
LIKE-KIND EXCHANGES INVOLVING PARTNERSHIPS

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October 27, 1989
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**I. Introduction**

A. **Uncertainty abounds.** Partnerships are commonly used to hold, own and operate improved and unimproved real estate because of the generally favorable tax treatment accorded partnerships under the Internal Revenue Code ("IRC"), including income taxation on the flow-through basis, the opportunity to contribute property to, and distribute property from, a partnership on a non-recognition basis, the rules for determining the basis of a partner's partnership interest, the liquidation of a partnership is generally a non-recognition event and the ability to allocate specifically items of income or deduction among the partners.

Notwithstanding this generally favorable tax treatment, like-kind exchanges of property which is held by or to be held by a partnership may be problematical because of the "held" and "to be held" requirements under §1031. The interpretation of these requirements by the Internal Revenue Service ("IRS") may result in the disallowance of §1031 benefits for like-kind exchanges of property which is held by a partnership prior to an exchange and distributed to the partners thereafter or the exchange property is contributed to a partnership after an exchange. Similar issues are raised in connection with a like-kind exchange which is preceded by a distribution of property from a partnership or after the subject exchange. The interpretations of these requirements by the Tax Court and the Ninth Circuit in several recent cases have been favorable to taxpayers, but these decisions and their rationale may be flawed. Furthermore, the holdings of these cases may not be good authority for exchanges which are subject to recharacterization as an exchange of partnership interests. Accordingly, planning for exchanges of like-kind property involving partnerships can be challenging and subject to uncertainty.

II. **General Discussion of §1031**

A. **Congressional intent**

1. The Congressional intent not to impose a tax on economic gain from an exchange (if there is no receipt of cash to pay the tax), where the taxpayer continued its investment in like-kind property, provided the basis for retaining the predecessor provision to §1031 when Congress

**The author acknowledges with appreciation the assistance of Todd H. Reuben, also with Tucker, Flyer, Sanger & Lewis, in preparing this outline.**
considered its repeal in 1934. In addition, the legislative history recognized the administrative burden that would be imposed in detecting and evaluating the multitude of exchanges effected each year. H.R. Rep. No. 704, 73d Cong., 2d Sess. 12 (1934). The continuity of investment reason has been generally cited by the courts.

2. While Congress probably only anticipated two-party exchanges, §1031 has evolved to encompass such sophisticated transactions as three- and four-party exchanges. It should be noted, however, that the courts and the IRS have taken the position that an exchange will be accorded non-recognition treatment only if it complies with the express terms of §1031.

3. As discussed below, notwithstanding the fact that a taxpayer may have essentially continued its investment in like-kind property, the IRS in its interpretations of §1031 has accorded equal weight to all the statutory requirements of §1031 rather than treating continuity of investment as the primary requirement imposed by Congress.

B. Statutory provisions of §1031(a)(1)

1. §1031(a)(1) provides that:

"No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like-kind which is to be held either for productive use in a trade or business or for investment" (emphasis added).

2. The basic requirements of §1031(a)(1) are set forth below:

(a) Property is transferred and property is received.

(b) The property transferred is exchanged for the property received.

(c) The property transferred was held for productive use in a trade or business or for investment (the "held requirement").
The property received is to be held for productive use in a trade or business or for investment (the "to be held requirement").

The property transferred and the property received must be like-kind and not excluded by reason of §1031(a)(2).

C. Statutory provisions of §1031(a)(2)

1. §1031(a)(2) provides that §1031(a) shall not apply to any exchange of:

   (A) stock in trade or other property held primarily for sale;
   
   (B) stocks, bonds, or notes;
   
   (C) other securities or evidences of indebtedness or interest;
   
   (D) interests in a partnership;
   
   (E) certificates of trust or beneficial interests; and
   
   (F) choses in action.

2. The Deficit Reduction Act of 1984 enacted §1031(a)(2)(D) to provide that exchanges of interests in partnerships would not qualify for non-recognition treatment under §1031(a)(1). The legislative history cited the potential for abusive tax planning by exchanging an interest in a burned-out tax shelter partnership for an interest in another partnership as a basis for this exclusion. Prior to this enactment, case authority permitted §1031 exchanges of partnership interests under certain conditions. Though the stated Congressional rationale was a concern about tax shelter partnerships, the exclusion in §1031(a)(2)(D) applies to all partnership interests, not solely interests in tax shelter partnerships.

III. The "Held" and "To be Held" Requirements of §1031(a)(1)

A. General discussion

A taxpayer must satisfy both the "held and the "to be held" requirements of §1031(a)(1). The property being
transferred must have been "held" for productive use in a trade or business or for investment and the property received is "to be held" for either of such uses. Although there is ample authority interpreting §1031, this authority has generally addressed such issues as the like-kind requirement, the agency issue, constructive receipt of sales proceeds, deferred exchanges and the mechanics of multi-party transactions. The "held" and "to be held" requirements have received relatively little attention.

B. Relationship of the holding requirements and exchanges involving partnerships

Subchapter K of the IRC generally provides non-recognition treatment for contributions of property to, and distributions of property from, a partnership. §721 generally provides for non-recognition treatment of a contribution of property to a partnership in exchange for a partnership interest. §731 generally provides for non-recognition treatment of a distribution of property from a partnership to a partner. The tax benefits of these non-recognition provisions may effectively be denied if a §721 contribution is preceded by an exchange or if a §731 distribution is followed by an exchange.

The uncertainty involving the relationship of these non-recognition provisions in Subchapter K, the "held" and "to be held" requirements under §1031(a)(1) and the satisfaction of these requirements by the holding of the subject property by a related entity creates the difficulty for planning in this area. If property presently owned by a partnership is distributed to a partner or a group of partners, and if in connection with a pre-arranged plan, the distributed property is exchanged for like-kind property which satisfies the "to be held" requirement, there is conflicting authority whether the "held" requirement can be satisfied by attributing to the partner the prior holding by the partnership. If the distribution precedes an otherwise qualified exchange under §1031, there is conflicting authority whether a transitory holding thereof by the distributee partner prior to an otherwise qualified exchange will satisfy the "held" requirement. Similarly, if property is exchanged in an otherwise qualified exchange and then contributed to a partnership, there is conflicting authority whether the taxpayer can satisfy the "to be held" requirement through attribution or otherwise. Further, there is conflicting authority whether a non-recognition event following the exchange protects the exchange although
the taxpayer cannot satisfy the "to be held" requirement on a direct ownership basis. The uncertainty in this area becomes particularly troublesome if a distribution of property from each of two separate partnerships to a partner of each partnership is followed by an exchange of such properties by such partners, and if the parties to the exchange then contribute their respective exchange properties to the other partnership. This transaction may be recharacterized as an exchange of partnership interests which is not entitled to non-recognition treatment.

Planning for the disposition of property held by a partnership when there is no mutual agreement among the partners to effect an exchange at the partnership level or there is a desire to acquire separately different exchange properties will create difficulties for those partners desiring exchange treatment because of the "held" and "to be held" requirements.

C. Interpretations of the IRS of the "held" and "to be held" requirements

1. Revenue Ruling 57-244, 1957-1 C.B. 247. The taxpayer purchased real estate for the purpose of constructing his personal residence thereon, and thereafter abandoned that purpose and then held the real estate for investment. After holding the property for a five year period, the taxpayer exchanged such property for investment property. The IRS held that §1031 treatment was available which indicates that taxpayer intent and length of time the property is held for a qualified purpose are both relevant with respect to the "held" requirement. Furthermore, the taxpayer's initial intent with respect to property will not deny tax-free treatment if the taxpayer's holding of the property prior to the exchange satisfies the "held" requirement.

2. Revenue Ruling 75-291, 1975-2 C.B. 333. The taxpayer acquired certain land and constructed improvements thereon in order to effect an exchange for land and improvements held by another party. The IRS disallowed exchange treatment because the taxpayer did not hold the property for either productive business use or for investment but rather held the property to effect an exchange.
3. Revenue Ruling 77-297, 1977-2 C.B. 304. In a prearranged three-party transaction, B, the accommodation party, purchased C's real estate and immediately exchanged it for property held by A. The IRS held that although A qualified for like-kind treatment, B failed to qualify because it acquired the property solely to effect an exchange.

4. Revenue Ruling 77-337, 1977-2 C.B. 305. The sole owner of a corporation exchanged improved property distributed from the corporation in a §333 liquidation for like-kind property owned by an unrelated party as part of a pre-arranged plan. The IRS denied §1031 treatment stating that the productive use of the improvements by the corporation prior to the liquidation cannot be attributed to its sole shareholder. The improved property had been acquired by the taxpayer solely to effect an exchange. It should be noted, however, that the taxpayer did not acquire the property with an intent to liquidate the same or hold it for personal purposes.

5. Revenue Ruling 75-292, 1975-2 C.B. 333. Taxpayer undertook a like-kind exchange and subsequently contributed the property received to his wholly owned corporation in exchange for stock thereof. The IRS held that the property received by the taxpayer in the exchange was not held for a qualified purpose because the property was transferred to the corporation and the holding thereof was not attributable to the shareholder. It should be noted, however, that the taxpayer did not acquire the property with an intent to liquidate the same or hold it for personal purposes.

D. Summary regarding the positions of the IRS. Although §1031 does not impose a specific holding period to satisfy either the "held" or "to be held" requirement, a short holding period may be indicative of a lack of intent or actual holding of the property for a qualified purpose. Property which is acquired whether from an unrelated party or a related party (including through a non-recognition event) in order to effect an exchange will not generally satisfy the "held" requirement based on the Revenue Rulings discussed above. The length of the holding period, when a pre-arranged plan has been adopted to facilitate a subsequent exchange, would not appear to remove the taint of the initial intent. The taxpayer's intent at
the time of the exchange appears to be the key factor with respect to the "to be held" requirement. Pre-arrangements to transfer the subject property, as well as a short holding period, may serve as objective facts to rebut the taxpayer's stated subjective intent. It should be noted, however, that changes in intent subsequent to the exchange should not adversely affect the availability of §1031 treatment unless the holding period is so short as to rebut the stated intent.

E. Judicial interpretations of the "to be held" requirement in exchanges followed by gifts

1. *Wagensen v. Comm.*, 74 T.C. 653 (1980). The taxpayer exchanged a ranch for like-kind property and approximately nine months thereafter gifted the property to his children. The court permitted like-kind treatment despite the short period citing the lack of an existing plan to gift when the exchange was effected. That factor, when coupled with the fact that the property received was of the type used in taxpayer's business, was sufficient to satisfy the "to be held" requirement.

2. *Click v. Comm.*, 78 T.C. 225 (1982). Seven months after exchanging his farm land for residential property, the taxpayer gifted such property to his children and spouse, who had been occupying the residence during this seven month period. The court denied nonrecognition treatment and held that the residence was acquired in order to gift the residence to his family rather than for a qualified investment purpose. The critical factor distinguishing *Click*, *supra*, from *Wagensen*, *supra*, was the existence in *Click*, *supra*, of a concrete plan at the time of the exchange to gift the acquired property. While a pre-arrangement will generally result in disallowance of §1031 treatment, a "general desire" to transfer property in the future may not be deemed inconsistent with a present investment or business intentions.

F. Judicial interpretations involving attribution between an entity and its owner

1. General discussion of prearranged multi-step transactions. The availability of §1031 treatment with respect to exchanges by a partnership with a subsequent distribution of the exchange property to a partner(s) or a distribution from the partnership followed thereafter by the partner's
exchange of such property will be dependent upon attribution of a qualified purpose or judicial gloss upon §1031 by reason of certain other non-recognition provisions. The attribution of a holding purpose may turn on whether the IRS adopts an aggregate versus the entity characterization of a partnership. With respect to §1033, the IRS and the Tax Court have adopted an entity characterization. See Demirjian v. Comm., 457 F.2d 1 (3rd Cir. 1972), aff'd 54 TC 1691 ( ). As noted above in Rev. Rul. 77-337, 1977-2 C.B. 305, the IRS denied the taxpayer nonrecognition treatment because the productive use by the corporation prior to liquidation was not attributable to the taxpayer. Similarly, in Rev. Rul. 75-292, 1975-2 C.B. 333, the IRS held that attribution was not available from a corporation to a shareholder where the exchange property had been contributed to the corporation by its sole shareholder. Accordingly, if the IRS adopts the entity theory for purposes of §1031, consistent with these Revenue Rulings, a preceding distribution from, or a subsequent contribution to, a partnership in connection with an exchange would result in disallowance of §1031 treatment. With respect to the latter, the IRS argued in Magneson v. Comm., 753 F.2d 1490 (9th Cir. 1985), aff'd 81 T.C. 767(1983) (detailed below) that the post-exchange contribution to a partnership disqualified the exchange.

2. Magneson v. Comm., supra. Pursuant to a prearranged transaction, the taxpayers exchanged a fee interest in an apartment building for a ten percent (10%) undivided interest in other real estate. This newly-acquired interest was immediately contributed to a limited partnership in return for a general partnership interest (the latter transaction being tax-free under §721).

a. Holding in Tax Court. The court held that the transaction qualified for like-kind treatment because the contributed property was merely a continuation of the partner's unliquidated investment in different form consistent with the underlying purpose of §1031. The continuity of investment in the partnership was evidenced by the carryover basis at the partnership level and similar ownership attributes between joint ownership and ownership of property by a partnership.
b. Holding in Ninth Circuit. The court employed the aggregate theory of partnership characterization in allowing a tax-free exchange under a two-step approach. It concluded that a partnership interest is merely an undivided interest in each asset of the partnership such that the transaction involved a exchange of real property for real property (as compared to the entity theory which would classify the partnership interest as personal property and thus disqualify the exchange). The court further stated that the attributes of ownership of a general partner are similar to those of tenants in common such that the conversion represents a mere change in form of ownership not significantly affecting the amount of control over the underlying asset. The "to be held" requirement of §1031 was satisfied through the attribution of the partnership's investment intent to the taxpayer based on the similarity of rights in the management of property between a general partner and a tenant-in-common.

c. Key factors potentially limiting the holding. The most critical factor noted by the Ninth Circuit was the fact that the decision was handed down without regard to new §1031(a)(2)(D) (not in effect at time of transaction). The case also involved the contribution of like-kind property for a general partner interest as opposed to a limited partner interest which lacks similarity with fee simple ownership. Furthermore, the court specifically limited its holding to situations where partnership's underlying assets were predominately of like-kind to the contributing partner's original investment.

3. Bolker v. Comm., 760 F.2d 1039 (9th Cir. 1985), aff'd.g. 782 81 T.C. (1983). The taxpayer received property pursuant to a tax-free §333 liquidation of his wholly-owned corporation. Subsequent to the adoption of the plan of liquidation but prior to the distribution of corporate assets, the taxpayer negotiated a like-kind exchange involving the property to be received in liquidation. The taxpayer consummated the like-kind transaction after holding the property for a period of three months.
a. Holding in Tax Court. In relying on its decision in *Magneson*, 81 T.C. 767 (1983), aff'd, 753 F.2d 1490 (9th Cir. 1985), handed down earlier that day, the court held that the exchange qualified for nonrecognition under §1031. Based on the continuity of investment theory consistent with that advanced in *Magneson*, supra, the court reasoned that the taxpayer's form of ownership was "essentially the same" both before and after the corporate liquidation. The court further noted the similarity of principles underlying §§333 and 1031 in holding that under both provisions, the taxpayer has neither cashed in nor closed out his investment.

b. Holding in Ninth Circuit. The Ninth Circuit affirmed the Tax Court's decision but reached its conclusions by interpreting the "plain language" of §1031. The court held that the taxpayer satisfied the "held" requirement because he continued to hold the property as an investment without intending to liquidate or use the property for personal pursuits. Thus, the corporation's qualified investment purpose was attributed to the taxpayer in order to satisfy the "held" requirement of §1031. Furthermore, the court may have adopted a new standard with respect to the "held" requirement which may expand the availability of §1031 treatment by equating the lack of intent to liquidate or use property for personal use as satisfying the "held" requirement.

c. Important factors cited to prevent the application of the step-transaction doctrine (as raised by the dissent). In addition to the proper intent to continue investment, the property was held as a tenant-in-common for a sufficient period prior to the exchange (i.e., 3 months). Of further significance is the fact that the liquidation was planned prior to the contemplation of the §1031 transaction and was not intended to facilitate the exchange.

d. Flaws in the Bolker decisions. Although the Tax Court and the Ninth Circuit ultimately arrived at the same conclusion, that is, to
permit the taxpayer non-recognition treatment under §1031, the rationale underlying both decisions appears somewhat flawed and inconsistent.

(1) The Tax Court justified like-kind treatment by improperly equating the "to be held" requirement addressed in Magneson, 81 T.C. 767 (1983), aff'd, 753 F.2d 1490 (9th Cir. 1985), with the "held" requirement at issue in Bolker, 760 F.2d 1039 (9th Cir. 1985). In characterizing the factual differences between the cases as insignificant, the court has effectively merged the "held" and "to be held" requirements thereby avoiding the very issue presented in Bolker, supra, namely whether the corporation's qualified purpose may be attributed to its shareholder for purposes of satisfying the "held" requirement. The two holding requirements are separate and distinct prongs of §1031 such that the satisfaction of the "held" requirement cannot be implied merely by complying with a qualified purpose after the exchange. Furthermore, attribution of investment intent from a partnership to its general partners for purposes of the "held" requirement is more reasonable than attributing such intent from a corporation to its shareholders. The court ignored the fact that a corporation is an entity separate and distinct from its shareholders, thus making the implied attribution analysis in Magneson, supra, inapplicable to the corporate scenario in Bolker, supra. In addition, the court's comparison of §§333 and 1031, which focuses on similar continuity of interest principles, appears misguided. Although it may be argued that both provisions provide for the deferral of gain or loss, §1031 imposes upon the continuity of investment concept certain specific statutory requirements (i.e., the holding requirements). Conversely, the provisions of then §333 did not impose a subsequent "to be held" requirement for non-recognition treatment thereunder.
Although the Ninth Circuit focused on the proper issue of whether the property exchanged was "held" for a qualified purpose, its reasoning in support of the taxpayer appears weak. The court has "softened" the "held" requirement by de-emphasizing the time period for holding the property prior to the exchange and the intent to use for a qualified purpose. In effect, it has interpreted an "intent to exchange" to being sufficient for satisfying the "held" requirement thus almost negating the need for attribution of holding purpose between the corporation and the taxpayer.

4. Maloney v. Comm., 93 T.C. No. 9 (Filed July 25, 1989). Pursuant to a prearranged plan, a corporation exchanged investment property for like-kind property, which was immediately distributed to its sole shareholder in a tax-free corporate liquidation.

   a. Holding. The Tax Court held that the exchange qualified for non-recognition treatment under §1031 based on the theories advanced in Magneson, 81 T.C. 767 (1983), aff'd, 753 F.2d 1490 (9th Cir. 1985), and Bolker, 760 F.2d 1039 (9th Cir. 1985). The court stated that those cases stood for the proposition that the addition of a second nontaxable transaction (§721 contribution or §333 distribution) would not disqualify a transaction from non-recognition treatment under §1031. The court stated that the sequence of transactions should not disrupt the underlying purpose of deferring gain or loss when the form of the investment remains unliquidated and only slightly modified. The holding is clearly based upon an attribution of the corporate asset to the shareholder.

   b. Questions potentially raised on appeal by IRS. As in Bolker, supra, the Tax Court in Maloney, supra, has seemingly ignored the holding requirements of §1031 and implicitly attributed the "to be held" investment purpose of the shareholder to the corporation or treated the taxpayer as the indirect owner.
prior to the exchange. Rather than specifically addressing the "to be held" prong of §1031, the court focuses on the continuity of interest principle in support of the taxpayer's investment intent. The court expands upon the definition of "liquidation" for purposes of §333 by emphasizing the receipt of property rather than "cashing out" of the taxpayer's investment. Based on the lack of discussion of the holding requirement and overemphasis on continuity of the taxpayer's economic interest, the Maloney, supra, decision appears susceptible to attack at the appellate level.

5. Mason v. Comm., 55 CCH T.C.M. 1134, 1988 PH TC Memo ¶88,273 (1988). Parties owning identical interests in two different partnerships entered into a sales contract to separate their business interests. The contract provided that each partnership would be completely liquidated with each partner receiving a divisible interest in the partnerships' assets and liabilities. The contract further provided that the partners would convey certain property interests received in liquidation so as to enable each to individually own one hundred percent of the assets of a specified partnership. Immediately thereafter, taxpayer exchanged his interest in miscellaneous partnership assets for his former partner's interest in other parcels of real estate. The court held that the pro-rata distribution of property upon liquidation (§731) followed by a like-kind tax-free exchange will not result in the recognition of gain or loss. Implicit in this holding was the attribution of the each partnership's holding purpose to its respective partner. Tax-free treatment was preserved because the exchange was considered to have occurred at the individual level, as property owners, rather than an exchange of partnership interests. Of particular importance was the language of the sales contract, which referred to individual conveyances of property rather than partnership conveyances. The fact that the partnership dissolution occurred prior to the sales transaction also proved important.

6. Additional planning technique as suggested by Chase v. Comm., 92 T.C. No. 53 (Filed April 29, 1989). The taxpayer, a limited partner, who effectively controlled the partnership through its
corporate general partner, desired to effect a like-kind exchange of its indirect interest in the assets of the partnership. In anticipation of a disposition of the partnership assets, the taxpayer caused a deed conveying an undivided interest to be delivered to taxpayer, which was not recorded upon delivery but held until immediately before the disposition. With the exception of the execution and delivery of the unrecorded deed, the partnership conducted business in the same manner, and taxpayer did not act in any manner as a tenant-in-common. The disposition proceeds were distributed in accordance with the partnership agreement rather than among tenants-in-common. Accordingly, the court determined that the taxpayer's failure to respect the form of its transaction was consistent with the fact that taxpayer was not a direct owner of the asset (which would have contravened the partnership agreement). Therefore, the disposition was treated as occurring at the partnership level, and the requirements of §1031 were tested at the partnership level. The court held that the transaction did not qualify because the partnership never held the property that were ultimately received by taxpayer as part of the "exchange". The exchange property which was acquired by the taxpayer was acquired and deeded to taxpayer through a trust which received the taxpayer's share of the disposition proceeds.

If the factors cited in the decision regarding the form of the transaction were properly observed by a taxpayer so that the taxpayer was treated as engaging in the exchange rather than the partnership, then this decision may be helpful in structuring future transactions. Although not necessary to reach its decision, the court did not address the issue of whether the taxpayer could satisfy the "held" requirement if the form of the transaction had been respected. Considering its holdings in Magneson, supra, and Bolker, supra, it may be reasonable to infer that a pre-arranged distribution to a partner would not disqualify an otherwise qualifying exchange thereafter in the Tax Court.

IV. Exchanges Involving Property Held by a Partnership

A. Exchanges by a Partnership. If the partners of a partnership decide to effect an exchange and there is a mutual agreement among the partners with respect to the
exchange property, then the partnership should engage in the exchange and hold the exchange property thereafter. If the exchange otherwise qualifies at the partnership level, then §1031 treatment would flow through the partnership to the partners under §702(a). In this situation, it would clearly be preferable for the partnership to effect the exchange and avoid any issues involving the "held" on "to be held" requirements by not distributing the partnership property to the partners in contemplation of the exchange.

B. Exchanges involving property previously held by a partnership. There are numerous factual situations which may arise which make impossible the simple planning described in the preceding discussion. For example, one partner may desire to effect an exchange and the other partners desire to effect a taxable disposition or the partners desire to acquire different exchange properties and to hold the same in a manner other than the existing partnership. A partner may desire to withdraw from the partnership and to receive an in-kind distribution therefrom and to effect an exchange thereafter. Prior to the Maloney, supra, decision, the planning for such transactions would generally be based upon the holding in Bolker, supra. Pending a decision of the Fifth Circuit if the IRS appeals decision in Maloney, supra, it may be preferable to rely on Bolker, supra, than Maloney, supra. The following discussion will review several planning alternatives in order to effect the exchanges described above.

1. Withdrawal of partner and continuation of partnership.

If one partner desires to withdraw from the partnership and the remaining partners desire to continue the partnership, and if there is a separate asset held by the partnership which would otherwise be acceptable as an in-kind distribution to the withdrawing partner, then the partnership could make a distribution of the same in liquidation of the partner's interest which would generally not be a taxable event. If the distribution is not made as a part of a pre-arranged plan to effect a subsequent exchange, and if the partner holds the same for a qualified purpose for a reasonable period of time, then a subsequent exchange thereof should not run afoul of the IRS's position regarding the "held" requirement.
However, if the distribution is made in contemplation of a pre-arranged exchange, then the partner will need to rely on Bolker, supra, and Mason, supra, to satisfy the "held" requirement. The IRS has not acquiesced to either decision, and the IRS may attempt to distinguish Bolker, supra, by arguing that the partner was not the sole indirect owner of the property prior to the distribution. The partner could argue forcefully that if the ownership of corporate property can be attributed to a shareholder for purposes of the "held" requirement (in the context of the general tax law treatment of a corporation being a separate and distinct taxpayer), then attribution from a flow-through entity which is treated as an aggregate of its partners for certain tax purposes is more plausible than the facts in Bolker, supra. If the partner attempted to rely on Magneson, supra, as authority, and if the withdrawing partner is a limited partner, then the IRS could argue that the rationale of Magneson, supra, is not applicable.

Rather than a distribution followed by an exchange, the transaction could be structured as an exchange followed by a distribution. If so structured or recast by the IRS, then the IRS may assert that the exchange fails the "to be held" requirement because the partnership effected the exchange in order to distribute the exchange property. The taxpayer may rely on Maloney, supra, in this situation, but this holding has not been upheld by an appellate court at this time.

If two partners desire to effect an exchange and one partner wants to dispose of his interest in a taxable sale, then it may be preferable to redeem the interest of the partner who desires a taxable sale and allow the other partners to continue the partnership (and the redemption should not result in a §708 termination) and effect the exchange at the partnership level. This should avoid the uncertainty regarding the holding requirements.

2. **Complete liquidation of partnership.**

a. If the partners otherwise desire to terminate the partnership and to pursue independent business pursuits, then it may be preferable to distribute the assets of the partnership to the same as tenants-in-common rather than
effecting multiple exchanges at the partnership level followed by non-pro-rata distributions to the partners (because the partnership may not be able to satisfy the "to be held" requirement). If the partners have not located or otherwise arranged their respective exchanges, each partner should be in a better position to satisfy the "held" requirement in a manner consistent with the IRS's interpretation of the same.

b. The liquidation could be deemed a sham or without effect such that the co-tenancy arrangement could be recast as continuing partnership. It is possible that the tenancy-in-common may not be a partnership under state law, but satisfy the definition of a partnership for tax purposes. See Reg. §1.761-1(a): co-ownership of property may constitute a partnership.

c. Measures to prevent characterization of joint ownership of property into a continuing partnership arrangement:

(i) limit the degree of services provided to property and its tenants to those "customarily provided" or hire independent agent (management co.) to render additional services as required.

(ii) the operating expenses should be pro-rated and separately paid by each co-owner.

(iii) publish the dissolution of the partnership as notice to third parties that the property is now owned as a tenancy in common.

C. Withdrawal of partner, pre-arranged exchange and recontribution of property

1. A partnership may distribute property in liquidation of a partner's interest to facilitate a like-kind transaction while, at the same time, seek future use of such property. This can be accomplished through either the "recontribution" of the property by the third party partaking in the like-kind exchange or through leasing the property from such third party. The former may
adversely affect the tax treatment of the preceding exchange.

a. Recontributions of property. The primary case in which the partnership acquired ownership of previously-liquidated property is *Crenshaw v. United States*, 450 F.2d 472 (5th Cir. 1971).

b. In *Crenshaw*, *supra*, the taxpayer attempted to exchange a liquidating partnership distribution for a direct interest in real estate under the following scenario:

(i) the taxpayer received an undivided percentage interest in a partnership asset in liquidation of her interest.

(ii) the taxpayer exchanged that interest for an interest in another piece of real estate owned by a related party ("X").

(iii) X then sold this interest for cash to a corporation owned by another partner in taxpayer's old partnership.

(iv) the corporation then transferred its newly acquired interest to the partnership in exchange for the partnership interest formally owned by taxpayer.

Under the step transaction doctrine, the court recharacterized the series of transactions as a direct sale of the partnership interest for the acquired real estate. The technical sequence of the pre-planned exchanges (including taxpayer's transitory holding of the real estate previously owned by X) was ignored for lack of a conceivable business purpose.

c. In *Crenshaw*, *supra*, the court decided to treat the transaction as a sale of a partnership interest rather than a liquidation of the same because the ultimate owner of the distributed property acquired an interest in the partnership. Accordingly, if a partner exchanges the distributed property for like-kind property, and the other party to the exchange contributes the property back to the partnership, then the transaction may be recharacterized as a taxable exchange of a partnership interest for real property. If
the other party to the exchange had acquired the property which it transferred in the above exchange in a distribution from a partnership, and if the exchange parties contribute their respective exchange properties to the other party's former partnership, then applying the same analysis in Crenshaw, supra, the parties could be treated as exchanging partnership interests.

d. Avoiding the recontribution of property. Any exchange of property which is preceded by a distribution in liquidation of a partner's interest in the partnership and followed immediately or after intervening steps by a contribution of such property to the same partnership is vulnerable to attack as an exchange of the partnership interest rather than the property. If the business objectives of the partnership and the exchanging party (the party who entered into the exchange with the withdrawing partner) can be achieved through a lease of the property to the partnership, the holding of the Tax Court in Harris v. Commissioner, 61 T.C. 770 (1974), may offer a planning vehicle.

In Harris, supra, a partnership distributed a partial ownership interest in a partnership asset in complete liquidation of the recipient partner's interest. The taxpayer then leased his undivided interest back to the partnership and thereafter sold such interest to a third party. The court had to determine whether there was a sale of the partnership interest or the distributed property. The court in Harris, supra, respected the form of the transactions because the taxpayer's interest in the partnership was absolutely liquidated. Of critical importance was the fact that the distributed property was not recontributed to the partnership. Rather than selling the distributed property, the former partner could effect a like-kind exchange and rely on Bolker, supra, for purposes of the "held" requirement. Relying on Harris, supra, the former partner would treat the transaction as an exchange of the distributed property rather than its partnership interest.

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Lessons to be learned from the Crenshaw and Harris decisions

(i) Avoid "recontribution". The party ultimately acquiring the distributed property should not transfer the property interest back to the original partnership which had distributed such property.

(ii) Alternative to "recontribution". The party acquiring the former partnership property in a §1031 transaction with the withdrawing partner and the partnership could enter into a net lease arrangement. The lease terms should be structured to preserve the exchange party's status as lessor and to avoid possible recharacterization as a constructive partner.

V. Structuring an Exchange Without a Constructive Exchange of Partnership Interests. Partners in two different partnerships may seek to acquire property currently owned by the other partnership in a tax-free exchange. Assuming the partnerships own other assets which will remain in the partnership (i.e., the partnerships remain in existence), certain untested planning techniques may accomplish such objectives while avoiding disqualification under §1031(a)(2)(D).

A. Partnership exchange with special allocations. The §1031 exchange could take place between the two partnerships with the partnerships then specially allocating the operations of the property received to the partner seeking such treatment.

1. Potential obstacles

   a. Allocations require "substantial economic effect". Pursuant to Reg. §1.704-1(b), allocations of partnership income, gain, loss, deduction and credit must have "substantial economic effect" or otherwise be "in accordance with the partners' interests in the partnership" to be respected.

   b. Drafting and filing requirements. Changing the tax arrangement between the partners usually necessitates an amendment to the partnership agreement and partnership certificate (if required to be filed).
c. Deemed partnership distribution. The transactions could result in a deemed partnership distribution of the property which is subject to the special allocation due to lack of sharing by all partners of the partnership, which may then fail the "to be held" requirement of §1031 because the property may be deemed to be held for the sole benefit of one partner, which, arguably, is economically the same as merely holding the property as a nominee, with a constructive distribution to the partner subsequent to the exchange.

B. Partnership exchange followed by distribution. An exchange of properties at partnership level followed by a tax-free distribution to a partner desiring such property may be effective. The risk in this arrangement, however, is the potential for each partnership to fail the "to be held" requirement of §1031.

C. New partnership to accomplish exchange. The parties seeking to obtain the reciprocal benefits of the other party's partnership interest could transfer their respective interests in existing partnerships to a newly-formed partnership which may then specially allocate the tax and economic incidents. The special allocation could be overridden by a mandatory allocation of income, gain, loss, and deduction under §704(c) which prevents the artificial shifting of tax consequences with regard to pre-contribution appreciation. However, if there is no sharing or commingling of the contributed interests, then the contribution of the same, with due regard to the effect of the special allocations, is arguably a constructive or disguised exchange of partnership interests. A transfer of properties to the partnership coupled with a distribution of such properties may be treated as a disguised sale or exchange under §707(a)(2)(B). A facts and circumstances test should be applied to determine whether the above transaction should be recharacterized as a taxable exchange of a partnership interest.

VI. Special Problems Involved in Partnership Deferred Exchanges.

A. The §752 trap. In a concurrent like-kind exchange, the liabilities of which are relieved are netted against those assumed to calculate boot for gain recognition purposes. In a non-simultaneous or deferred exchange, however, the temporary relief of liabilities prior to
netting could result in gain recognition in an otherwise qualifying §1031 transaction. Representatives of the IRS have stated informally that the new regulations under §1031 may allow for netting in a deferred exchange. However, their regulations will not modify the liability sharing rules under §752. If encumbered property of a partnership is exchanged without immediate netting, there will be a relief of partnership liabilities resulting in a deemed cash distribution. Under §752(b), a decrease in a partner's share of partnership liabilities is deemed a cash distribution to such partner. Thus, the Subchapter K rules requiring current tax treatment of reduction in partnership liabilities will adversely affect deferred §1031 transactions absent express language in the regulations permitting netting of liabilities on a deferred basis.

B. Guidance on deferred exchanges from §1033 transactions.

1. Revenue Ruling 81-242, 1981-2 C.B. 147. A partnership elected to defer the recognition of gain on its building which was involuntarily converted. At the time of conversion, the liabilities secured by the building exceeded the partnership's basis as well as the partners' basis in their interests in the partnership. The partnership used a portion of the condemnation proceeds to pay off the debt. The Service held that although the partnership gain could be deferred, the partners would recognize gain due to the non-simultaneous nature of the condemnation and reinvestment. Even though the partnership timely elected §1033 treatment, a deemed distribution of cash resulted from the repayment of the partnership mortgage. Thus, gain was recognized by the partners because the condemnation and potential replacement of the property could not be integrated.

2. Letter Ruling 8041061. The partnership desired to distribute the remaining portion of a piece of property which had been partially condemned. The distribution was to allow the partners to hold the property as tenants in common so that the individual partners could reap the benefits of §1033 deferral should the remaining portion be condemned. The IRS held that the individual partners could utilize §1033(a) if the partnership terminated and the liquidating distribution was ultimately condemned. However, because the partnership terminated, the property held by the
taxpayer would not be deemed to be held for business use or investment purposes for §1033(g) deferral purposes.

3. Letter Ruling 8818029. The partnership distributed an entire parcel of land to its partners in anticipation of condemnation. The land was to be held as a tenancy in common with the proceeds to be received directly by the partners upon actual condemnation. The Service held that the partners could qualify individually for §1033 treatment when the property is distributed after the threat of condemnation but before the beginning of condemnation proceedings. Thus, assuming the relationship among the former partners is a co-tenancy rather than a deemed partnership, the former partners can defer gain which may otherwise be recognized as a deemed distribution of cash under §752(b).