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TAX NEWS

Tax-Free Exchanges of Property Contributed to or Distributed From a Partnership

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This month's column explains special issues that may arise in qualifying an exchange of real property for tax-free treatment under IRC §1031 when the property involved in the exchange is distributed from or contributed to a partnership before or after the exchange.

Background on IRC §1031

Internal Revenue Code §1031(a)(1) generally permits property to be exchanged solely for like-kind property on a tax-free basis. The statute also requires that both the property surrendered and the property acquired be held for productive use in a trade or business or for investment ("the holding requirement"). The IRS has ruled that property acquired or constructed solely for the purpose of completing an exchange does not satisfy the holding requirement. Rev Rul 77-297, 1977-2 Cum Bull 304; Rev Rul 77-291, 1975-2 Cum Bull 332. There is no clear rule, however, regarding how long property must be held. If property involved in an exchange is distributed from a partnership or contributed to a partnership before or after the exchange, the question arises whether that fact affects the taxpayer's ability to satisfy the holding requirement.

Further, under IRC §1031(a)(2)(D), tax-free treatment does not apply to an exchange of interests in a partnership. Note that an exchange of interests in the same partnership may qualify for tax-free treatment under the partnership provisions of the Internal Revenue Code. See Rev Rul 84-52, 1984-1 Cum Bull 157.

Both the holding requirement and the prohibition on exchanges of partnership interests, as well as the tax law doctrine of substance over form, may be implicated if a purported IRC

§1031 exchange occurs close in time to a distribution of property from, or contribution of property to, a partnership.

Distribution Before Exchange by Partners

Two key court decisions illustrate the risks that may be associated with an IRC §1031 exchange completed shortly after the property to be exchanged has been distributed from a partnership.

In *Delwin G. Chase* (1989) 92 TC 874, JMI, a limited partnership, was formed to purchase, operate, and hold an apartment building. In anticipation of a possible sale of the building, Chase, a limited partner, caused the partnership to distribute to him a deed for an approximate 46-percent undivided interest in the building, intending that he could complete a tax-free exchange of that interest for other property. This distribution might not have been properly authorized under the partnership agreement.

Later, the partnership received an offer from an unrelated party to purchase the building. Chase attempted to create a tax-free exchange with respect to the 46-percent interest that was covered by the deed. He asked an accommodation party (the Ellis Trust) to (1) acquire the 46-percent interest, (2) complete the sale thereof to the buyer, and (3) use the sales proceeds to acquire replacement property to be delivered to Chase.

The court found several weaknesses in Chase's plan. The general partner of JMI, in its capacity as such, dealt exclusively with the buyer as to the entire building. There was no indication that the buyer, or JMI's broker, even knew that Chase had any individual ownership interest in the building. Chase recorded the deed only after he was certain that the sale to the buyer was going to close. Chase signed the escrow agreement for closing the sale, but on behalf of JMI, not in his individual capacity. Up until the time of sale, Chase did not, in his individual capacity, bear any of the expenses, or receive any of the income, associated with the building. The cash eventually received by the Ellis Trust was found by the court to be Chase's distributive share of JMI's net sales proceeds allocated to him in his capacity as a partner. The court may have also been influenced by the fact that, before the acquisition of the replacement properties, a corporation wholly owned by Chase became the trustee of the Ellis Trust, the intermediary in the purported exchange.

Substance Over Form

The Tax Court concluded that, in substance, the transaction was a sale by JMI of the entire apartment building, not an exchange by Chase of his portion of the building. The court relied on *Commissioner v Court Holding Co.* (1945) 324 US 331, 89 L Ed 981, 65 S.Ct. 707, and *U.S. v Cumberland Pub. Servo Co.* (1950) 38 US 451, 94 L Ed 251, 70 S Ct 280, two well-known Supreme Court decisions delineating when a sale by shareholders of property distributed by a corporation will be respected as being made by the shareholders rather than by the corporation. The Tax Court also held that IMI could not be treated as having completed an IRC §1031 exchange, because IMI never received and held the replacement property, which was instead received by Chase.

Chase must be contrasted with *Miles H. Mason*, TC Memo 1988-273. In *Mason*, the taxpayer terminated two 50-50 general partnerships (Sky Valley and IV) with McClure. The end result was that McClure owned directly all of the assets formerly held by Sky Valley, as well as some of JV's former assets, and Mason owned the rest of JV's former assets.

The IRS argued that the partners had made a nonqualifying exchange of partnership interests. The court found that the transaction had occurred in the following steps: (1) the two partnerships terminated and distributed their assets in liquidation to Mason and McClure; and (2) Mason and McClure then exchanged their personal interests in the distributed properties. The court found that this exchange qualified for IRC §1031 treatment, basing its finding on the fact that the contract between Mason and McClure referred repeatedly to personal exchanges of assets held individually.

Lessons from Chase and Mason

A comparison of *Chase* and *Mason* leads to some guidelines for planning such transactions. *Chase* followed none of the formalities necessary to establish that he had actually received his 46-percent interest from the partnership before the sale, or that he had dealt directly with the buyer with respect to the disposition of that interest. In *Mason*, by contrast, the language of the contract was consistent with an exchange of personal interests in property, not an exchange of partnership interests. Yet the taxpayers in *Mason* did not take all the steps that would be desirable from a planning perspective to ensure that the intended tax treatment was obtained. The contract was less than clear in several respects. In particular, it did not specify clearly that the partnerships had terminated and distributed their assets or that these events occurred before the exchange. In planning any exchange following a distribution from a partnership, partners should carefully document all steps and the order in which they occur. Further, any partner desiring exchange treatment should conduct all negotiations regarding the exchange of his interest in the property directly with the buyer. Finally, a partner should document carefully when he or she is acting in his or her individual capacity rather than on behalf of the partnership.

The Holding Requirement

Neither *Chase* nor *Mason* mentioned the holding requirement. The result in *Mason* implies that the court found this requirement to be satisfied. Because the opinion does not discuss the issue specifically, it is not clear whether Mr. Mason was considered to have satisfied the holding requirement based on his brief ownership of the property before the exchange, or whether he was entitled to count the period that the partnership held the property. *Magneson v Commissioner* (9th Cir 1985) 753 F2d 1490, affg (1983) 81 TC 767, discussed below, implies that the partner receiving the distribution may be treated as holding the property for purposes of IRC: §1031 while it is held by the partnership. *Magneson*, however, involved a contribution to a partnership rather than a distribution from a partnership. There is no authority directly addressing the holding requirement in the context of a partnership distribution preceding an exchange.

It should also be noted that *Mason* was a general partner; *Magneson* also involved a general partner. Because of a general partner's management powers, a general partner may be thought to have a closer connection to the property while it is held by the partnership than does a limited partner. In fact, there does not appear to be any authority directly supporting the

conclusion that a limited partner can satisfy the holding requirement after a distribution. There is, however, one favorable court decision regarding a liquidating distribution from a corporation. See *Joseph R. Bolker* (1983) 81 TC 782, affd (9th Cir 1985) 760 F2d 1039. Thus, it is possible that limited partners could also be found to satisfy this requirement.

(Note that there has been some disagreement among the courts and the IRS when property is received in a liquidating distribution from a corporation and is later exchanged for other property. In Rev Rul 77-337, 1977T 2 Cum Bull 305, an exchange immediately following a liquidating distribution from a corporation was held not to qualify under IRC §1031. The liquidation was made under IRC §333 (repealed in 1986), pursuant to which gain was generally not recognized, and the shareholder took over the corporation's basis for the property distributed. In *Joseph R. Bolker*, supra, an exchange following a corporate liquidating distribution (also under IRC §333) was found to qualify under IRC ~1031. The court's rationale for its decision is not entirely clear. At one point the court distinguished Rev Rul 77-337 on the grounds that Mr. Bolker's intent to exchange arose after the decision to liquidate was made and that the property was actually held for three months before the exchange took place. The court also stated, however, that acquisition of property with an intent to exchange satisfied the holding requirement.)

Contribution Following an Exchange by Partners

In *Magneson v Commissioner* (9th Cir 1985) 753 F2d 1490, affg (1983) 81 TC 767, the taxpayers exchanged the "Iowa Street" property for a 10-percent undivided fee interest in the "Plaza" property, which was held by NER. Immediately after the exchange, the taxpayers and NER contributed their interests in the Plaza property to a partnership. The taxpayers received a general partner interest.

The Ninth Circuit held that the contribution did not disqualify the exchange. The court concluded that, for purposes of IRC §1031, the taxpayers continued their investment in the property after the contribution. The court cited the following factors in support of its conclusion: (1) a general partnership interest was received; (2) the purpose of the partnership was to hold the property for investment; and (3) the partnership's total assets were predominantly of like kind to the property contributed by the taxpayers.

The court also cited with favor decisions holding that exchanges of general partner interests in partnerships with similar assets qualified under IRC §1031. *Magneson* involved the tax year 1977. The Internal Revenue Code was amended in 1984 to preclude exchanges of partnership interests from qualifying under IRC §1031. Thus, part of the court's rationale for its decision may be undercut by the 1984 legislation. In the corporate area, Rev Rul 75-292, 1975-2 Cum Bull 333, held that an exchange was disqualified under IRC §1031 when property received in the exchange was immediately transferred to the taxpayer's newly created wholly owned corporation. The IRS determined that the holding requirement was not satisfied.

Distribution Following an Exchange by Partnership

Another possible variation is that an IRC §1031 exchange by a partnership may be followed by a distribution to the partners of the property received in the exchange. There does not appear to be any authority specifically dealing with this type of transaction in the case of a

partnership. In *Bonny B. Maloney* (1989) 93 TC 89, an exchange of properties by a corporation, which was followed in less than one month by a liquidation of the corporation under IRC ~333, was held to qualify under IRC §1031. This suggests that a similar result may apply to an exchange by a partnership. It is also possible that a court could give favorable treatment only to general partners and not to limited partners.

Contribution Before an Exchange by Partnership

No cases or rulings appear to have addressed the tax treatment of an IRC §1031 exchange by a partnership when the property was contributed to the partnership shortly before the exchange. Presumably, the principles discussed above should apply in determining the tax treatment of these transactions.

Importance of Partnership Status

Practitioners should keep in mind that an arrangement that is not a partnership for state law purposes (e.g., an undivided interest in property held as a tenant in common) may, in certain circumstances, be characterized as a partnership for federal income tax purposes. See *Real Property Exchanges* §2.38 (2d ed Cal CEB 1994). Thus, what appears to be an exchange of individual interests in property might be viewed as an exchange of partnership interests for tax purposes.

Conclusion

As the preceding discussion indicates, there is some uncertainty regarding the effect on a purported IRC §1031 exchange of a distribution from, or contribution to, a partnership closely preceding or following the exchange. The courts have tended to view such transactions more favorably than the IRS. There is no clear indication that the IRS has been persuaded to adopt the courts' point of view, but the Service has lost most of its attempts to challenge such transactions. If feasible from a business standpoint, the taxpayer should try to impose an interval (the longer the better) between the exchange and the contribution or distribution. If business considerations dictate little or no time interval, the transaction should be carefully documented to minimize any risk under *Court Holding Co.* and to ensure that the form of the transaction supports the desired tax treatment.