CHICAGO DEFERRED EXCHANGE COMPANY

PARTNERSHIP PROBLEMS IN LIKE-KIND EXCHANGES

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Internal Revenue Code Section 1031(a)(2) excludes the exchange of a partnership interest, except where the partnership has in effect a valid election under Section 761(a) to be excluded from the application of all of subchapter K, in which case the interest shall be treated as an interest in each of the assets of the partnership, and not as an interest in a partnership.

A partnership includes a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation or venture is carried on and which is not a corporation, trust or estate.

The term "partnership" is broader in scope than the common-law meaning of a partnership, and may include groups not commonly called partnerships. (See Code § 7701 (a)(2)). A joint undertaking merely to share expenses is not a partnership. For example, if two or more persons jointly construct a ditch merely to drain surface water from their properties, they are not partners.

Mere co-ownership of property which is maintained, kept in repair, and rented or leased does not constitute a partnership. For example, if an individual owner, or tenants in common of farm property lease it to a farmer for a cash rental or share of the crops, they do not necessarily create a partnership thereby.

Co-owners or tenants in common, however, may be partners if they actively carry on a trade, business, financial operation or venture and divide the profits thereof. For example, a partnership **does** exist if co-owners of an apartment building lease space and, in addition, provide more than customary services to the tenants either directly or through an agent. (See Reg. § 1.761-1).

Election under Section 761(a)

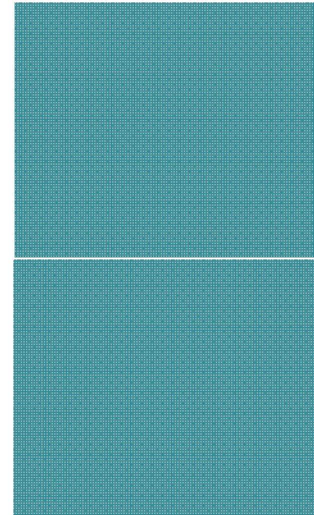
An unincorporated organization described above may be excluded from the application of all or a part of the provisions of subchapter K of chapter 1 of the Code provided that the organization is for investment purposes only and not for the active conduct of a trade or business. The members of the organization must be able to compute their income without the necessity of computing partnership taxable income, and any syndicate, group, pool or joint venture which is classifiable as an association is not eligible for this election. The members of the organization must meet a three-pronged test:

1. Own the property as co-owners, and,

2. Reserve the right separately to take, encumber, or dispose of their shares of any property acquired or retained, and,

3. Do not actively conduct business or irrevocably authorize some person or persons acting in a representative capacity to purchase, sell or exchange such investment property for a period of more than one year.

There is no IRS form for making an election out of partnership status under Section 761(a). The following is a draft form only:



ELECTION TO BE EXCLUDED FROM PARTNERSHIP PROVISIONS

Name of Entity: ____

EIN: ____

Statement of Election under IRC Section 761(a)

Election is hereby made pursuant to §761(a) of the Internal Revenue Code of 1986, as amended, and the Regulations thereunder, to be excluded from the application of all of Subchapter K of the Code. The following is submitted pursuant to Regulation 1.761-2(b)(2):

Name/Address/Social Security Number of Co-Owners:

1. ____
2. ____
3. ____
4. ____

The co-owners qualify for this election under subparagraphs (1) and (3) of Regulation 1.761-2(a). All of the co-owners elect to be excluded from all of subchapter K. A copy of the agreement of the co-owners is available at the offices of: ____.

If an election under Section 761(a) is not feasible, then the problems typically faced by a practitioner can be analyzed under one of the following three scenarios:

1. Distribution followed by an exchange. (“Drop and Swap”)
2. Preplanned contribution into a partnership.
3. Partnership level exchange followed by drop-down. (“Swap and Drop”)

An analysis of each of these variations reveals separate tax and business planning risks and opportunities:

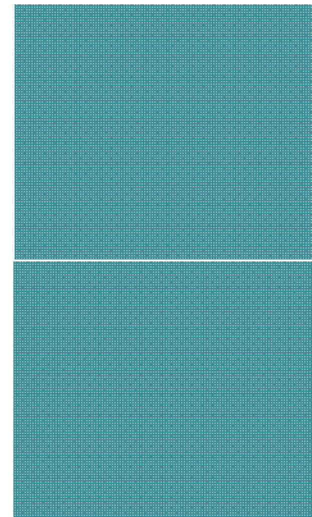
Distribution followed by an exchange – “Drop and Swap”

A distribution or partial distribution of property from a partnership which is immediately thereafter transferred by the partner-transferee in an exchange raises the issue of whether the immediate transfer after the distribution violates the “held for investment” requirement of Section 1031.

In Rev. Rul. 75-292, 1975-2CB 333, the IRS took the position that a transaction may not qualify under Section 1031 if the property acquired is immediately disposed of in a subsequent nontaxable transaction under Section 351, particularly if the subsequent transfer is prearranged.

In Rev. Rul. 77-377, 1977-2CB 305, the IRS denied 1031 treatment to a Taxpayer who received an asset in a nontaxable Section 333 liquidation and immediately thereafter transferred the property in a purported 1031 exchange.

While these published rulings involved nontaxable transfers to or from a corporation, it was generally believed that the IRS would take a similar position with regard to transfers to or from a partnership, although there is presently no published ruling guidance in this context.



In **Chase v. Commissioner**, 92 T.C. 874 (1989) the partnership issued a deed conveying an undivided 46.3527 % interest in the partnership property to the Taxpayer. The Taxpayer never received any rental income directly from the tenants, never paid any operating expenses of the property, the deed was not recorded until immediately before the closing of the sale, and the sale contract was executed only by the partnership.

These flaws caused the court to conclude, based on Court Holding Co. v. Commissioner, 2 T.C. 53(1943) that "in substance, (the partnership) disposed of the apartments." Since the partnership did not enter into a Section 1031 exchange, there was no exchange.

In **Mason v. Commissioner**, T.C. Memo 1988-273 (1988) two partners liquidated two partnerships and then exchanged properties so that each partner ended up owing all of the properties previously owned by one of the partnerships.

The IRS argued that each partner had sold his interest in a partnership to the other, but the Tax Court disagreed, holding that the exchanges by former partners, of property received from their just-terminated partnerships, constituted valid like-kind exchanges. Even though this is only a Tax Court Memo, it lends important insight into the question of whether the partnership's holding period will tack to the partner/distributee.

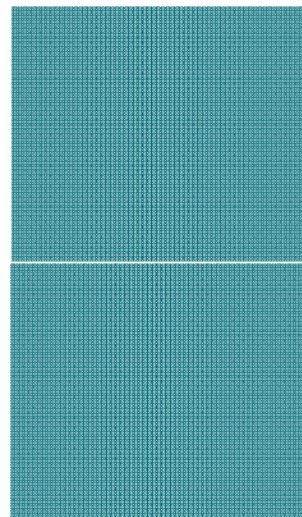
See also **PLR 9741017** where two brothers desired to exchange their interests with each other in ten separate investment properties and the Service ruled it was an exchange of partnership interests and therefore non-qualifying property for purposes of Section 1031.

Preplanned Contribution into a Partnership

Assume the Taxpayer disposes of property in a Section 1031 exchange and acquires replacement property which is immediately contributed to a partnership under Section 721 in exchange for a general partner interest in the partnership.

In **Magneson v. Commissioner**, 753 F. 2d 1490 (9th Cir. 1985) the Ninth Circuit Court of Appeals affirmed the Tax Court's reviewed decision that the 10 percent undivided interest satisfied the "held for productive use or investment" requirement of Section 1031 despite the Taxpayer's intent to exchange it for a general partner interest in a partnership. The Appeals Court analyzed (California) state law and concluded that the Taxpayer had "changed the form of their ownership of real estate from tenancy in common to a general partner interest in a partnership, but they continue to own like-kind investment property, albeit in a different form of ownership".

The court confined its holding to a contribution of property to a partnership in exchange for a general partnership interest. It was repudiating the rationale of Rev. Rul. 75-292 denying 1031 treatment to a like kind exchange followed by a Section 351 transfer to a corporation. "Transfer to a corporation in exchange for shares is distinguishable from transfer to a partnership for a general partnership interest in several important ways" said the court, emphasizing that the corporation owns property in its own right, whereas the partners own the assets of the partnership as tenants in partnership. The court also emphasized that Section 1031 (a)(2) excluded corporate stock, but that there was "no such prohibition on exchanges of partnership interests". The year involved was 1977. IRC Section 1031(a)(2) was amended to exclude the exchange of interests in a partnership in 1984.



It could be argued that the Magneson reasoning should still apply in the case of exchange of property for a general partner interest in a partnership because of the underlying nature of a general partner's interest in the partnership property. But the interest in partnership assets of a limited partner, or similarly, of an LLC member in the LLC assets is clearly not the same as that of a general partner.

Partnership-level exchange followed by drop-down – "Swap and Drop"

In **Maloney v. Commissioner**, 93 T.C. 89 (1989) the Taxpayer corporation liquidated under Section 333 immediately after acquiring replacement property. The IRS took the position that the Taxpayer did not continue to hold the replacement property for productive use or investment but rather distributed the property to its shareholders.

The Taxpayer, citing **Bolker v. Commissioner**, 760 F 2d 01039 (9th Cir. 1985) emphasized that the tax basis of the real property received in the 333 liquidation was equal to the tax basis of the stock surrendered, and therefore the gain should be deferred until the real estate was liquidated. The Court concluded, "under Section 333, when the Taxpayer surrenders stock in his corporation for real estate owned by the corporation, he continues to have an economic interest in essentially the same investment, although there has been a change in the form of ownership. His basis in the real estate acquired on liquidation is equal to his basis in the stock surrendered."

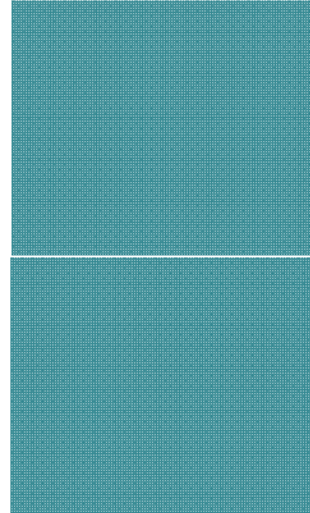
The Tax Court viewed the transaction as a variation of the transactions it had already blessed in Magneson and Bolker and ruled that 1031 applied.

The rationale of Bolker and Maloney is even more compelling when applied to the liquidation of a partnership, and Section 732 will provide for a substitution of basis from the partnership interest to the transferee. In the words of the Maloney Court, "we have already held that Section 721 and Section 333 transactions are not incompatible with Section 1031 tax free exchanges" and it follows that Section 731 distributions in which the basis of property is determined under Section 732 would achieve the same result.

In other non-corporate contexts the IRS has indicated that it will not view a transaction as outside of Section 1031 merely because it is prearranged or because the property received is disposed of shortly thereafter in a nontaxable transfer. In PLR 8126070 the IRS sanctioned a 1031 exchange by a non-grantor trust which was required to transfer exchange property received.

Notice 2004-53: Election out of Subchapter K

Background: §1031(a) provides that a partnership that has a valid election under §761(a), to be excluded from the application of all of Subchapter K of the Internal Revenue Code (covering Partners and Partnerships) will be treated as an interest in each of the assets of the partnership and not as an interest in the partnership.



The following three requirements must be met to qualify for the election:

1. The participants must own the property as co-owners,

2. The participants must reserve the right separately to take or dispose of their shares of any property acquired or retained, and

3. The participants must not actively conduct business or irrevocably authorize some person acting in a representative capacity to purchase, sell or exchange the property.

In FSA 199923017 (March 5, 1999) the Service ruled that limited partnerships formed under State law were not eligible to elect out of subchapter K holding that the partners did not have the right to take their share of the partnership property at will.

Similarly in FSA 200216005 (January 10, 2002), the Service ruled that a limited partnership could not elect out of subchapter K because ownership of a partnership does not give a partner the right to take separately or dispose of its share of the partnership property (Presumably the Service would reach the same conclusion about a multi-member state formed LLC). In many cases the co-owners will not be able to meet the requirements of the election and so it is of limited practical use.

The Notice: In Notice 2004-53 the Service has shown its willingness to reconsider this prohibition against state formed entities making the election under §761 and has solicited comments on whether the conditions should be revised, modified, or clarified. Additionally the Service has solicited comments on what facts should be considered in determining whether participants in the joint purchase, retention, sale or exchange of investment property have reserved the right to separately take or dispose of their underlying share of the property.

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