1991

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THE LIKE-KIND EXCHANGE OF PARTNERSHIP INTERESTS UNDER IRC SECTION 1031(a)(2)(D): AN HISTORICAL ANALYSIS OF ALTERNATIVE APPROACHES

Vincent John Piazza*

I. Introduction

Before the Tax Reform Act of 1984, general partnership interests were considered like-kind property which could be exchanged tax-free under Internal Revenue Code ("IRC") section 1031(a). Prior to 1984, the Internal Revenue Service ("IRS") had tried unsuccessfully to convince the courts that the parenthetical clause of section 1031(a), which excludes certain exchanges of interests from the definition of like-kind property, encompassed all types of equity interests. Since the IRC did not specifically exclude partnership interests, judges were very reluctant to adopt the IRS's over-expansive reading of the statute. After making very little headway with the courts, the IRS and treasury turned their attention in Congress. As a result, in 1984 Congress enacted IRC section 1031(a)(2)(D) which explicitly excludes partnership interests from the definition of like-kind property eligible for nonrecognition treatment.


1. Prior to 1984, 26 U.S.C. § 1031(a) provided:
   NONRECOGNITION OF GAIN OR LOSS FROM EXCHANGE SOLELY IN KIND. — No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidence of indebtedness or interest) is exchanged solely for property of like kind to be held either for productive use in trade or business or for investment.


3. See cases cited supra note 2.

   NONRECOGNITION OF GAIN OR LOSS FROM EXCHANGES SOLELY IN
The legislative history of IRC section 1031(a)(2)(D) reveals that Congress had two overriding policy objectives for enacting that provision. First, the House Ways & Means and Senate Finance Committees believed that partnership interests were very similar to stocks, bonds and other securities or indebtedness and thus should also be excluded from like-kind exchange treatment. This reasoning was not surprising since the IRS had been making a similar argument for about thirteen years before this subsection was enacted.

Second, Congress perceived an abuse in the like-kind exchange arena with respect to "burnt-out" partnerships. In a burnt-out partnership, the cash distributions to a partner are insufficient to pay the tax liability on the income allocable to him. This situation occurred in many tax shelters where the losses incurred in the first few years of operation were due mainly to unpaid nonrecourse liabilities. Since the initial losses often reduced the partner's outside basis to a nominal amount, many partners were left with a difficult choice: they could sell their partnership interest and be forced to recognize large gains, or they could hold onto their partnership interests, but then the cash distributable to them would be insufficient to pay the tax on their share of the partnership's income.

Accordingly, many investors exchanged their interest in a burnt-
out partnership for an interest in a partnership with much healthier cash flow. Assuming the burnt-out partnership had a section 754 election in effect, section 743(b) allowed the partner exchanging his interest in the target partnership to increase his adjusted basis in the burnt-out partnership's assets equal to his old basis. Since the section 743(b) adjustment was personal to the target partner and did not show up on the books of the burnt-out partnership, in effect this adjustment shielded the target partner from future partnership gains. This technique was particularly attractive to limited partners in real estate tax shelters who could benefit from a stepped-up basis attributable to the partnership's nonrecourse debt.

Despite these two objectives, House Report number 98-432 provided for nonrecognition treatment with respect to exchanges of partnership interests in the same partnership. This implies that Congress was more concerned with eliminating the bailout from burnt-out partnerships than it was with fostering the IRS's historical argument that partnership interests were too similar to stocks and bonds to be afforded nonrecognition treatment. Before legal counsel can adequately plan around the parameters of section 1031(a)(2)(D), however, congressional intent must be supplemented with prior and subsequent case law.

II. HISTORICAL PERSPECTIVE (PRE 1984)

A. Exchange of Partnership Interests

Miller v. United States was the IRS's first reported challenge to a direct exchange of partnership interests. Miller involved an exchange of a fifty percent general partnership interest in a tavern for a twenty-five percent general partnership interest in an auto supply store. Noting that the statute did not specifically exclude

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11. Id.
12. Section 754 allows a partnership to elect to adjust the basis of partnership property at the time an interest in the partnership is transferred by sale of exchange. I.R.C. § 754 (1986).
13. See Burke, supra note 9, at 468.
14. See id.
15. Id.
18. 63-2 U.S. Tax Cas. (CCH) ¶ 9608, at 89,450 (S.D. Ind. 1963).
19. Id. at 89,451-53.
partnership interests, the federal district court judge held that the exchange was merely a continuation of the taxpayer's unliquidated investment, and therefore, the exchange was tax-free under section 1031(a). From the court's brief opinion, it is apparent that the court was reluctant to expand the literal reading of the statute. Since Congress did not expressly exclude the exchange of partnership interests from like-kind exchange treatment under section 1031(a), the court did not embrace the government's overexpansive argument that the parenthetical exception to section 1031(a) included all types of equity interests. Moreover, once the court found that an exchange of partnership interests did not constitute "stock in trade," it did not inquire into the underlying assets of the partnership and therefore did not notice that the ratio of hot assets to total assets was over sixty-seven percent.

The IRS waited until 1972 before it again challenged a direct exchange of partnership interests. In Estate of Meyer v. Commissioner, a father and son exchanged their interests in a general partnership for interests in a much larger limited partnership. Both partnerships were involved in the rental of real estate. The son received a general partnership interest, and the father received a limited partnership interest. The Tax Court, relying on Miller, held that the son's exchange of a general partnership interest for a general partnership interest qualified for nonrecognition treatment under section 1031(a). The court went further than Miller, however, by specifically limiting its holding to situations where both partnerships own the same type of underlying assets, in this case, rental real estate.

Although both partnerships in Estate of Meyer contained the same type of underlying assets, the court limited its decision further by holding that the father's exchange of his general partnership interest for a limited partnership interest did not qualify for nonrecognition treatment under section 1031(a). The court reasoned that under the Uniform Partnership Act and the Uniform Limited Partnership Act, the differences between a general and a

20. 63-2 U.S. Tax Cas. (CCH) ¶ 9606, at 89,453.
21. Id.
22. 58 T.C. 311 (1972), aff'd per curiam, 503 F.2d 556 (9th Cir. 1974).
23. Id. at 312.
24. Id.
25. Id. at 314.
26. Id.
27. Id.
limited partnership interest were so substantial that they could not be considered property of like-kind. Judge Dawson, dissenting, believed that the majority "illogically bifurcated identical exchanges of 'property' which occurred simultaneously." Although he stated that the majority was correct in emphasizing that the underlying property of both partnerships was rental real estate and therefore of like-kind, he disagreed with the court's requirement that the attributes of a general and a limited partnership interest also had to be of like-kind. In retrospect, it appears as if Judge Dawson was advocating an aggregate theory of partnership taxation, whereas the majority employed both an aggregate and entity approach.

Even though Estate of Meyer was a partial victory for the IRS, the IRS still did not acquiesce in the decision since the court had sanctified the tax-free exchange of general partnership interests when the underlying property was of like-kind. In fact, the IRS went so far as to publish Revenue Ruling 78-135, which specifically stated that an exchange of general partnership interests would not qualify for nonrecognition treatment under section 1031(a). The IRS's rationale was two-fold: first, the parenthetical language of section 1031(a) encompassed all types of equity interests, including partnership interests; and second, section 741 was the exclusive provision providing for the recognition of gains or losses on the sale or exchange of partnership interests. Since a section 1031 transfer falls within the ambit of "exchange," section 741 was purportedly consistent with the exclusion of partnership interests from nonrecognition treatment under section 1031(a). In Gulfstream Land & Development Corp. v. Commissioner, the IRS tried a new twist on an old theme. Gulfstream involved a like-kind

28. Id.
29. Id. at 315.
30. Id. at 315-16.
33. Id. at 257.
34. Id. The ruling states that:
   Section 741 of the Code provides, in part, that in the case of a sale or exchange of an interest in a partnership gain or loss shall be recognized to the transferor partner. Thus, section 741, which requires recognition of gain or loss, is in conformity with the parenthetical clause of section 1031(a), which excepts exchanges of equity interests in financial enterprises from nonrecognition under section 1031.

35. Id.
exchange of joint venture interests.\textsuperscript{37} The IRS argued that joint venture interests were "evidence of . . . [an interest]" and were within the parenthetical exception to section 1031(a) nonrecognition treatment.\textsuperscript{38} The Tax Court, relying on prior precedent, rejected this argument on the basis that Congress did not intend to include partnership interests as "evidences of interest" within the meaning of the parenthetical exception to section 1031(a).\textsuperscript{39} However, the court's analysis did not stop there. The court also denied the petitioner's motion for partial summary judgment because an unresolved question remained as to whether the underlying assets of the two joint ventures were in fact of like-kind or whether the assets constituted prohibited stock in trade.\textsuperscript{40}

Two years later, in \textit{Long v. Commissioner},\textsuperscript{41} the Tax Court employed the same analysis in a similar factual setting. In \textit{Long}, the taxpayer had exchanged a general partnership interest for an interest in a joint venture that, like the general partnership, was engaged in the rental of real estate.\textsuperscript{42} The court first found that the exchange of a general partnership interest for a joint venture interest did not come within the parenthetical exception to section 1031(a).

The court then turned its attention to the underlying assets of each activity.\textsuperscript{43} Approximately six weeks prior to the exchange, the partnership had adjusted its profit and loss sharing ratios, thereby reducing the taxpayer's share of liabilities from $1,426,681 to $756,680.\textsuperscript{44} Additionally, the joint venture had borrowed $400,000 before the exchange to increase its liabilities to approximately $750,000.\textsuperscript{45} To determine whether the exchange qualified under section 1031, the court relied on an entity theory of partnership taxation.\textsuperscript{46} Although the Tax Court acknowledged that section 1031(b) authorized the netting of liabilities to delay recognition of

\textsuperscript{37} 71 T.C. at 589-91.
\textsuperscript{38} Id. at 593-94 (citing Meyer v. Commissioner, 58 T.C. 311, 313 (1972), aff'd, 503 F.2d 556 (1974)).
\textsuperscript{39} Id.
\textsuperscript{40} Id. at 594-97.
\textsuperscript{41} 77 T.C. 1045 (1981).
\textsuperscript{42} Id. at 1058-59.
\textsuperscript{43} Id. at 1066-68.
\textsuperscript{44} Id. at 1076 n.16.
\textsuperscript{45} Id. at 1079.
\textsuperscript{46} Id. at 1071-72; see William M. Keating, \textit{Congress Eliminated the Like-Kind Exchange of Partnership Interests — Or Did It?}, 64 Taxes 573, 576 (1986).
gain on an exchange,\textsuperscript{47} the court disregarded the liability adjustments as being motivated solely by a desire for tax avoidance and therefore lacking in economic substance.\textsuperscript{48} Accordingly, the amount of boot received by the taxpayer was computed in accordance with the provisions of subchapter K and section 752 in particular.\textsuperscript{49} As a result, the taxpayer's entire realized gain was required to be recognized.\textsuperscript{50}

The last significant Tax Court case before the Tax Reform Act of 1984 was \textit{Pappas v. Commissioner}.\textsuperscript{51} In \textit{Pappas}, the taxpayer exchanged his general partnership interest in an entity which owned and operated an apartment complex for a general partnership interest in an entity which owned and operated a hotel furnished and equipped with various personalty.\textsuperscript{52} The IRS first argued that the partnership interests represented "evidence of . . . [an] interest" within the meaning of the section 1031(a) parenthetical, but the court relied on \textit{Gulfstream} and \textit{Long} to summarily reject this contention.\textsuperscript{53}

Significantly, the IRS then contended that sections 741 and 1031 were conflicting "exchange" provisions and therefore section 741 should control because it was a more specific statute.\textsuperscript{54} The IRS used a variation of this theory in Revenue Ruling 78-135 to argue for the denial of nonrecognition treatment in a like-kind exchange of partnership interests.\textsuperscript{55} Despite the IRS's contentions, the court found that the two provisions were not conflicting, but rather distinguishable.\textsuperscript{56} Judge Goffe, speaking for a full court, found section 1031 to be a "nonrecognition" provision since it provides that neither gain nor loss may be recognized with respect to certain like-kind exchanges.\textsuperscript{57} In contrast, he declared section 741 to be a "characterization" provision since it provides that a partnership interest is to be treated as a capital asset, assuming section 751 is

\textsuperscript{47} \textit{Long}, 77 T.C. at 1078.
\textsuperscript{48} \textit{Id.} at 1077-80.
\textsuperscript{49} \textit{Id.} at 1072, 1080-82; see Keating, \textit{supra} note 46, at 576.
\textsuperscript{50} \textit{Long}, 77 T.C. at 1081-82.
\textsuperscript{51} 78 T.C. 1078 (1982).
\textsuperscript{52} \textit{Id.} at 1080.
\textsuperscript{53} \textit{Id.} at 1084-85.
\textsuperscript{54} \textit{Id.} at 1086.
\textsuperscript{56} \textit{Pappas}, 78 T.C. at 1086-87.
\textsuperscript{57} \textit{Id.}
not applicable.\textsuperscript{58} In sum, the court held that the taxpayer's exchange fell within the nonrecognition provisions of section 1031(a).\textsuperscript{59}

With respect to the hotel furniture and equipment, the court rejected the IRS's argument that such personalty should be treated as "boot" under section 1031(b).\textsuperscript{60} The court determined that the personalty was not stock in trade, as may have existed in Gulfstream, and then declined to explore the extent to which section 751(c) may have been applicable because neither party had raised the issue prior to trial.\textsuperscript{61}

\section*{B. The 1031 Holding Requirement}

After \textit{Estate of Meyer} and throughout the 1970's, the IRS mounted a more aggressive offensive against what it perceived as a potential abuse in the like-kind exchange area.\textsuperscript{62} In two closely related revenue rulings, the IRS took a very narrow view concerning the holding requirement that must be satisfied before nonrecognition treatment will be afforded under section 1031(a).\textsuperscript{63} In Revenue Ruling 75-292, the IRS held that a like-kind exchange of land and buildings which was immediately followed by a section 351 exchange failed to qualify for nonrecognition treatment under section 1031(a).\textsuperscript{64} The IRS's rationale was that the property exchanged was not "held" for investment or for productive use in a trade or business prior to the transaction.\textsuperscript{65}

In Revenue Ruling 77-337, the IRS held that a corporate liqui-

\begin{footnotesize}
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\item \textsuperscript{58} \textit{Id.}
\item \textsuperscript{59} \textit{Id.} at 1086.
\item \textsuperscript{60} \textit{Id.} at 1086-87.
\item \textsuperscript{61} \textit{Id.}
\item \textsuperscript{62} See, \textit{e.g.}, Bolker v. Commissioner, 760 F.2d 1039 (9th Cir. 1985), aff'd \textit{81 T.C.} 782 (1983); Magneson v. Commissioner, 753 F.2d 1490 (9th Cir. 1985), aff'd \textit{81 T.C.} 767 (1983); Barker v. United States, 668 F. Supp. 1199 (C.D. Ill. 1987); Maloney v. Commissioner, 93 T.C. 89 (1989); Wagensen v. Commissioner, 74 T.C. 653 (1980); Land Dynamics v. Commissioner, 37 T.C.M. (CCH) 1119 (1978).
\item \textsuperscript{64} Rev. Rul. 75-292, 1975-2 C.B. 333, 334.
\item \textsuperscript{65} \textit{Id.}
\end{itemize}
\end{footnotesize}
participation under former section 333, followed by the shareholder’s immediate exchange of the distributed property for like-kind property, also did not satisfy the section 1013(a) holding requirement.\textsuperscript{66} The support for this ruling, however, leaves much to be desired. In brief, the ruling states that a shareholder who receives property in a section 333 liquidation also acquires the corporate transferor’s holding period under section 1223(1). Then, the IRS cites Revenue Ruling 75-292 as support for its determination that the transaction is invalid under section 1031(a), without ever reconciling the ambiguity it created.\textsuperscript{67}

Although Revenue Rulings 75-292 and 77-337 were cast in the corporate context, they could have ramifications for partnership planning opportunities. For instance, why should a like-kind exchange of property followed by section 721 partnership contribution be viewed by the IRS any differently than a section 351 corporate contribution under Revenue Ruling 75-292?\textsuperscript{68} Alternatively, why should the IRS view a section 731 liquidating distribution to a partner, followed by a like-kind exchange of such property, any differently from the factual situation in Revenue Ruling 77-337?\textsuperscript{69} In fact, the IRS has relied heavily on these two rulings to press for denial of nonrecognition treatment to like-kind exchange transactions in the partnership context.\textsuperscript{70}

In Land Dynamics v. Commissioner,\textsuperscript{71} a real estate developer exchanged an orange grove for pasture land. Although the taxpayer held the pasture land for over one year before he sold it, the Tax Court nevertheless held that he did not satisfy the section 1031(a) holding requirement.\textsuperscript{72} Since the taxpayer was a real estate dealer, the court found it difficult to accept the taxpayer’s position that at the time of the like-kind exchange he intended to hold the prop-

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\textsuperscript{67} Id. One of the common attributes of nonrecognition provisions such as former § 333 or 1031 is the tacking of holding periods under § 1223(1). Nevertheless, the IRS abruptly disregards this similarity and summarily relies on Revenue Ruling 75-292.

\textsuperscript{68} See Magnesen v. Commissioner, 753 F.2d 1490, 1493-95 (9th Cir. 1985), aff’d 81 T.C. 767 (1983) (distinguishing transfer of property to a corporation in return for stock from transfer to a partnership for a general partnership interest and holding Rev. Rul. 75-292 inapplicable to a § 721 transfer).

\textsuperscript{69} See Mason v. Commissioner, 55 T.C.M. (CCH) 1134 (1988) (holding that property exchanged between partners following § 731 liquidation qualifies for nonrecognition treatment under § 1031(a)).

\textsuperscript{70} See, e.g., Magnesen, 753 F.2d at 1493.

\textsuperscript{71} 37 T.C.M. (CCH) 1119, 1119-20 (1978).

\textsuperscript{72} Id. at 1120-21.
property for investment purposes. Significantly, the court did not find that a dealer in real estate could not hold property for investment purposes, but rather that this particular taxpayer "had not submitted one iota of evidence in support of its investor status. . . ."

In *Wagensen v. Commissioner* the Tax Court concluded that nine months was a sufficient time period to satisfy the section 1031 holding requirement. The taxpayer in *Wagensen* received 18,000 acres of land in a like-kind exchange, used the land for nine months in his cattle business, and then gave half of the property to his children as a gift. *Wagensen* is clearly distinguishable from *Land Dynamics*, however, because the taxpayer used the exchanged property in his trade or business. The court viewed this productive use of the property as persuasive evidence that the taxpayer did not intend to dispose of the property when he received it in the exchange. In fact, the court noted that it did not matter whether the gift preceded or succeeded the like-kind exchange. The determinative factor was not how long the taxpayer held the property after the exchange or whether the transaction was combined with other nonrecognition provisions, but rather what the taxpayer's intent was at the time the exchange occurred.

III. HISTORICAL PERSPECTIVE (POST 1984)

As previously stated, section 1031(a)(2)(D), which was enacted by the Tax Reform Act of 1984, explicitly excludes the exchange of partnership interests from the general nonrecognition provisions of section 1031. The intent of Congress in enacting this statute was two-fold. First, Congress believed that partnership interests were closely akin to stocks, bonds and other types of equity interests and should be treated similarly. Second, Congress wanted to preclude nonrecognition treatment with respect to the exchange of

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73. Id.
74. Id. at 1121.
75. 74 T.C. 653, 658-59 (1980).
76. Id. at 656.
77. Id. at 658-59.
78. Id. at 660. The court noted "[t]o hold that the exchange in the instant case fails to qualify for nonrecognition treatment merely because the gift was made after the exchange rather than before it would exalt form over substance." Id. Cf. Biggs v. Commissioner, 69 T.C. 905, 914 (1978), aff'd, 632 F.2d 1171 (1980) (stating the substance of a transaction rather than its form determines tax consequences).
79. 74 T.C. at 658-59.
80. See supra note 4 and accompanying text.
burnt-out partnership interests. With these two policy objectives in mind, this section will now examine the case law subsequent to the Tax Reform Act of 1984.

A. The 1031 Holding Requirement

In 1985, the Ninth Circuit decided Magneson v. Commissioner. The taxpayers in Magneson held a fee simple interest in an apartment building for investment purposes. The taxpayers exchanged their fee simple interest for a ten percent undivided tenancy-in-common interest in another piece of commercial real estate. As part of a prearranged agreement, the taxpayers simultaneously exchanged their ten percent tenancy-in-common interest for a general partnership interest in a California limited partnership. The taxpayers argued that the exchange of their fee simple interest for a tenancy-in-common interest should have received nonrecognition treatment under section 1031(a). They also argued that their exchange of the tenancy-in-common interest for a general partnership interest should also have qualified under the nonrecognition provisions of section 721. In response, the IRS argued that the initial exchange did not qualify under section 1031(a) because the taxpayers failed to "hold" the property for investment purposes as required by Revenue Ruling 75-292.

The central issue of the case was whether the taxpayers' exchange of their tenancy-in-common interest for a general partnership interest was a liquidation of their old investment or a continuation of such investment unliquidated, but in modified form. The court focused on the similarities between the rights of a general partner and the rights of a tenant in common, as well as the continuity-of-investment theory underlying Regulation 1.1002-1(c).
The court was persuaded in its decision by the fact that had the taxpayers not contributed the property to the partnership, they might have been taxed as a partnership, depending on the level of business activity inherent in the property. The court concluded that, for tax purposes, there was no substantial difference between joint ownership of property and partnership ownership of property.

In his dissent, Judge Tannenwald argued that the majority had failed to properly analyze the differences between a tenancy-in-common interest and a general partnership interest, as well as the impact of California law. Judge Tannenwald believed that such an analysis would have shown that these interests were not of like-kind.

The Ninth Circuit affirmed after reviewing de novo the Tax Court's conclusions of law. Since federal law does not create or define property rights, the Ninth Circuit analyzed state law to determine the nature of the taxpayers' legal interest in the property at issue. The Ninth Circuit found that the differences between a tenancy-in-common interest and a general partnership interest were not significant enough to control for purposes of determining the section 1031(a) holding requirement. The court then found that the Magneson's contribution of the property to a partnership was a mere change in the form of ownership, not a relinquishment of such ownership. Therefore, the court held that the section 1031(a) holding requirement was satisfied and the exchange should be afforded nonrecognition treatment. It should be noted how-

example, by sections 351(a), 354, 361(a), 371(a)(1), 371(b)(1), 721, 1031, 1035 and 1036. These sections describe certain specific exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences are more formal than substantial. As to these, the Code provides that such differences shall not be deemed controlling, and that gain or loss shall not be recognized at the time of the exchange. The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated. . . .

91. Magneson, 81 T.C. at 773; see Treas. Reg. § 301.7701-3(a) (1963).
92. Magneson, 81 T.C. at 773.
93. Id. at 774.
94. Id.
95. Magneson, 753 F.2d at 1493.
97. Magneson, 753 F.2d at 1495.
98. Id. at 1497.
99. Id.
ever, that the court limited its holding to situations where the taxpayer's original investment and the partnership's underlying assets are of a like-kind.100

On the same day as it decided Magneson, the Ninth Circuit affirmed Bolker v. Commissioner.101 Bolker involved a corporate liquidating distribution of real property to a shareholder, followed by a prearranged exchange of the property for three parcels of realty owned by a savings and loan.102 Based on Revenue Ruling 77-337, which involved virtually identical facts, the IRS argued that the requisite holding period under section 1031(a) had not been satisfied.103

The Tax Court, relying on the decision in Magneson, held that the mere fact that the section 1031 exchange was preceded by a tax-free corporate liquidation was insufficient to destroy the validity of the like-kind exchange.104 In affirming, the Ninth Circuit emphasized that the section 1031(a) holding requirement only requires that the taxpayer not intend to use the investment for personal purposes or intend to liquidate it, not that the taxpayer has to intend to hold the property indefinitely.105

In both Magneson and Bolker the IRS attempted to invoke the step transaction doctrine.106 In Magneson, the Ninth Circuit found that even if the step transaction doctrine was applicable, the underlying property was of like-kind, and therefore the application of the doctrine would have had no effect.107 In other words, if the intermediate steps in Magneson were collapsed, there would have been an exchange of a fee simple interest for a general partnership interest. These two types of interest are considered like-kind

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100. Id. at 1498. "[T]he taxpayer must show . . . that the purpose of the partnership is to hold the property for investment, and that the total assets of the partnership are predominantly of like kind to the taxpayer's original investment." Id.
101. 760 F.2d 1039 (9th Cir. 1985), aff'd 81 T.C. 782 (1983).
102. Bolker, 81 T.C. at 790-794.
103. Id. at 804.
104. Id. at 805. The Magneson case involved a § 1031 exchange followed by a tax-free contribution to a partnership.
105. Bolker, 760 F.2d at 1045.
106. Id. at 1044; Magneson, 753 F.2d at 1497. Under the step transaction doctrine, the tax consequences of gains from a sale of property are determined by analysis of the transaction as a whole. Commissioner v. Court Holding, 324 U.S. 331, 334 (1945). Accordingly, "the incidence of taxation depends upon the substance of a transaction," not its formal structure. Id. at 334. This type of analysis prevents taxpayers from disguising the real nature of their transactions with mere formalities in order to change their potential tax liabilities. Id.
107. Magneson, 753 F.2d at 1497.
property.

In *Bolker*, the Ninth Circuit did not address the issue since the IRS had not argued this theory in the Tax Court below. The Ninth Circuit's decision to avoid the issue is rather perplexing when one considers that the first eight pages of the Tax Court's opinion is dedicated to a thorough analysis of the Supreme Court's landmark decision in *Court Holding Co. v. Commissioner* and its progeny.

In 1987, the government attempted to use the Ninth Circuit's rationale in *Bolker* against a taxpayer who wanted his transaction to be classified as a taxable purchase. In *Barker v. United States*, the taxpayer attempted to purchase fifty acres of farmland in Champaign County. Since the owner of the farmland wanted to structure the transaction in the form of a like-kind exchange, the taxpayer purchased a restaurant in Illinois as replacement property. Immediately after purchasing the restaurant, the taxpayer exchanged it for the farmland and then reported his acquisition of the farm as a taxable purchase. The government contended that even though the taxpayer did not intend to liquidate the restaurant or to use it for personal purposes, he held the property for sufficient time to come within the purview of section 1031(a).

The district court rejected the government's argument on the basis that the taxpayer's intent was merely to acquire the restaurant as a medium of exchange in order to effectuate the purchase of the fifty acres of farmland. Since the taxpayer was a farmer by trade, the court was persuaded that he did not have the requisite intent to acquire the restaurant as an investment or for the purpose of operating it as a trade or business. Furthermore, the

108. *Bolker*, 760 F.2d at 1042.
110. *Bolker*, 81 T.C. at 796-803. Moreover, the Ninth Circuit even stated that “[t]he Tax Court emphasized the admitted nonrecognition treatment accorded each individual step in the transactions, and reasoned that if each step were tax-free, in combination they should also be tax-free, so long as the continuity of investment principle underlying section 1031(a) is respected.” 760 F.2d at 1044.
111. 87-2 U.S. Tax Cas. (C.C.H) ¶ 9444 at 89,249 (C.D. Ill. 1987).
112. *Id.* at 89,249.
113. *Id.* at 89,249-50.
114. *Id.* at 89,250.
115. *Id.* at 89,251.
116. *Id.* at 89,252.
117. *Id.* The court noted,
court, citing Revenue Ruling 77-297, held that the taxpayer had effectuated a taxable purchase, whereas the other party to the transaction had negotiated a tax-free like-kind exchange.\textsuperscript{118} The taxpayer preferred a taxable purchase because certain investment credits he claimed were dependent on the transaction being classified as a taxable event.\textsuperscript{119}

The most recent case in this area is \textit{Maloney v. Commissioner},\textsuperscript{120} which was decided by the Tax Court in July of 1989. \textit{Maloney} involved a like-kind exchange of investment real estate between a corporation and two individual investors.\textsuperscript{121} After the exchange, the corporation was liquidated under old section 333 and the property received in the like-kind exchange was distributed to the taxpayer/shareholder.\textsuperscript{122}

The IRS attempted again to apply the Ninth Circuit’s rationale in \textit{Bolker} to \textit{Maloney}. The IRS argued that the section 1031(a) holding requirement could only be satisfied if the taxpayer did not have the “intent to either liquidate his investment or use it for personal pursuits.”\textsuperscript{123} A fortiori, since the corporation was liquidated immediately after the like-kind exchange, the Ninth Circuit’s standard could not have been satisfied.\textsuperscript{124} The Tax Court dismissed this argument by defining the term “liquidate” to mean reducing the property received to cash, marketable securities, or other property not of like-kind.\textsuperscript{125}

The IRS also argued that from the shareholder’s perspective, the exchange amounted to an exchange of stock for property.\textsuperscript{126} The court apparently was not persuaded by the IRS’s argument that under a step transaction analysis if the transaction was collapsed there would be a clear violation of section 1031(a)(2)(B). The court

\begin{itemize}
  \item The Barkers are farmers. It appears that they would have no use for a restaurant in furtherance of their business. Further, the Barkers only “owned” the restaurant for perhaps several minutes, for the sale was closed at the same time that the exchange was made with Keeling. Certainly, such ownership does not connote an intention to acquire for investment purposes.

\textit{Id.}
\end{itemize}

\textsuperscript{118} Id. at 89,251-52.
\textsuperscript{119} Id. at 89,250-51.
\textsuperscript{120} 93 T.C. 89 (1989).
\textsuperscript{121} Id. at 90-95.
\textsuperscript{122} Id. at 96-99.
\textsuperscript{123} Id. at 100.
\textsuperscript{124} Id.
\textsuperscript{125} Id.
\textsuperscript{126} Id. at 102.
dismissed the argument without discussion and held the exchange to be tax-free.\textsuperscript{127}

B. Exchange of Partnership Interest

Mason v. Commissioner\textsuperscript{128} was released by the Tax Court as a memorandum decision in June of 1988. Mason involved the same two partners in two separate partnerships.\textsuperscript{129} Both partnerships were liquidated, and the assets, consisting mostly of real estate, were distributed to the two individual partners.\textsuperscript{130} The individuals then entered into a like-kind exchange between themselves of the various parcels received in dissolution.\textsuperscript{131} The IRS challenged the exchange under section 741 as being, in substance, an exchange of partnership interests.\textsuperscript{132} Much to the taxpayer's chagrin, the court rejected this view and recharacterized the transaction as a tax-free liquidation under section 731, followed by a taxable like-kind exchange under section 1031(b).\textsuperscript{133} Since the taxpayer was relieved of liabilities in excess of the liabilities assumed, the taxpayer was required to recognize $302,680 of capital gain income.\textsuperscript{134}

A particularly troubling aspect of Mason is the court's failure to address the taxpayer's momentary holding of the liquidated property prior to the like-kind exchange.\textsuperscript{135} In addition, the court did not attempt to analyze the exchange under a step transaction analysis.

IRS Letter Ruling 89-120-23 provides that an exchange of a limited partnership interest for a general partnership interest, or vice versa, does not violate the like-kind exchange rules under section 1031(a)(2)(D) if the exchange involves the same partnership.\textsuperscript{136} This ruling indicates that Congress's intent in enacting section 1031(a)(2)(D) was to preclude the exchange of partnership interests in different partnerships, not the same partnership.\textsuperscript{137}

\textsuperscript{127} 93 T.C. at 102.
\textsuperscript{128} 55 T.C.M. (CCH) 1134 (1988).
\textsuperscript{129} Id. at 1135.
\textsuperscript{130} Id.
\textsuperscript{131} Id.
\textsuperscript{132} Id. at 1137.
\textsuperscript{133} Id. at 1137-38.
\textsuperscript{134} Id. at 1138.
\textsuperscript{136} Priv. Ltr. Rul. 89-120-23 (Dec. 22, 1988).
\textsuperscript{137} Id. "Congress intended, therefore, to deny like-kind treatment to the exchange of
Unfortunately, IRS Letter Ruling 89-120-23 was subsequently revoked, without explanation, by Letter Ruling 89-440-43.\textsuperscript{138} In Revenue Ruling 84-52, however, the IRS held that a conversion, within the same partnership, of a general partnership interest into a limited partnership interest, or vice versa, is tax-free under IRC section 721.\textsuperscript{139} Revenue Ruling 84-52 has not been subsequently modified or revoked, therefore it should be considered good authority.

Finally, as recently as 1989, the Treasury Department was still attempting to influence Congress with respect to the like-kind exchange provisions.\textsuperscript{140} Specifically, Treasury wanted a provision enacted requiring the parties in a like-kind exchange to hold their respective properties for one full year both before and after the exchange in order for the transaction to qualify for nonrecognition treatment.\textsuperscript{141} From a tax planning point of view, it was unfortunate that this provision was never enacted because it would have added stability and cohesiveness to the holding requirement cases previously discussed.\textsuperscript{142}

IV. AN ANALYSIS OF ALTERNATIVE APPROACHES TO 1031(A)(2)(D)

Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes. . . . [T]he meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create.\textsuperscript{143}

As the above quote from an opinion by Justice Learned Hand indicates, even great legal minds often have difficulty discerning

\begin{itemize}
\item \textsuperscript{138} Priv. Ltr. Rul. 89-440-43 (Aug. 8, 1989).
\item \textsuperscript{139} Rev. Rul. 84-52, 1984-1 C.B. 157, 158.
\item \textsuperscript{140} See H.R. 3150, 100th Cong., 1st Sess. Sec. 11601 (1989).
\item \textsuperscript{141} Id.
\item \textsuperscript{142} See supra notes 62-79 and accompanying text. But see James A. Fellows & Michael A. Yuhas, supra note 135, at 603 (discussing how this provision would have effectively "guillotined" the economic-unit/continuity-of-investment doctrine as enumerated in Magneson and Bolker).
\item \textsuperscript{143} Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934).
\end{itemize}
the fine line between legitimate tax planning and tax avoidance. However, it has now been eight years since section 1031(a)(2)(D) was enacted, and not one court decision has been handed down that interprets the parameters of this statute.\textsuperscript{144}

In an effort to provide some guidance, the remainder of this article will attempt to define the legitimate boundaries of this statute. In order to facilitate this analysis the following example and assumptions will be used:

**ABC PARTNERSHIP**

**Statement of Assets & Liabilities**

<table>
<thead>
<tr>
<th>Inside Adjusted Basis</th>
<th>FMV</th>
<th>Mortgage</th>
</tr>
</thead>
<tbody>
<tr>
<td>CASH $25,000</td>
<td>$25,000</td>
<td>$n/a</td>
</tr>
<tr>
<td>UNREALIZED REC. 0</td>
<td>50,000</td>
<td>n/a</td>
</tr>
<tr>
<td>APT # 1 5,000</td>
<td>60,000</td>
<td>10,000</td>
</tr>
<tr>
<td>APT # 2 15,000</td>
<td>75,000</td>
<td>50,000</td>
</tr>
<tr>
<td>APT # 3 45,000</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Totals $90,000</td>
<td>$310,000</td>
<td>$160,000</td>
</tr>
</tbody>
</table>

**Statement of Partner's Outside Adjusted Basis**

<table>
<thead>
<tr>
<th>Partnership Interest</th>
<th>Outside Adjusted Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partner-A 33%</td>
<td>$30,000</td>
</tr>
<tr>
<td>Partner-B 33%</td>
<td>30,000</td>
</tr>
<tr>
<td>Partner-C 33%</td>
<td>30,000</td>
</tr>
<tr>
<td>Totals</td>
<td>$90,000</td>
</tr>
</tbody>
</table>

**A. Intrapartnership Exchanges**

The IRS has given conflicting signals with respect to the like-kind exchange of partnership interests in the same partnership.\textsuperscript{145} As previously noted, Letter Ruling 89-120-23, which held that section 1031(a)(2)(D) applies only to like-kind exchanges between different partnerships, was revoked by the IRS without explana-

\textsuperscript{144} See supra notes 80-127 and accompanying text. All cases cited therein have been decided under I.R.C. § 1031(a) prior to the enactment of the Tax Reform Act of 1984, Pub. L. No. 98-369, § 77(a), 98 Stat. 494.

\textsuperscript{145} See supra notes 128-142 and accompanying text.
Some members of the tax bar have interpreted the IRS' action to mean that intrapartnership exchanges would fall within the section 1031(a)(2)(D) exception to nonrecognition treatment. However, Revenue Ruling 84-52 and the legislative history behind section 1031(a)(2)(D) suggest that an IRS challenge to an exchange of intrapartnership interests may be rather weak. Specifically, the committee reports suggest that Congress's reason for enacting section 1031(a)(2)(D) was to preclude the tax-free exchange of burnt-out partnership interests. Since intrapartnership exchanges would be consistent with achieving this goal, it appears that such exchanges should not be foreclosed to investors. Moreover, the fact that Revenue Ruling 84-52 has not been revoked or modified also supports the argument that intrapartnership exchanges should be afforded nonrecognition treatment under section 1031(a). In effect, Revenue Ruling 84-52 provides that the conversion of a partnership interest (general into limited or limited into general) within the same partnership is not a taxable event.

For example, assume that partners A and B are general partners in the ABC partnership and C is a limited partner. Further assume that B wants to convert and/or exchange his one-third general partnership interest into a one-third limited partnership interest. The central premise buttressing Revenue Ruling 84-52 is that section 721 applies to such a transaction. In short, section 721(a) provides that "[n]o gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership." Accordingly, in the context of a conversion, Revenue Ruling 84-52 holds that section 721 will govern this example notwithstanding the possible application of sections 741 or 1001.

Revenue Ruling 84-52 and Subchapter K in general are problematic because they do not provide a definition of "property." In the

148. See id.
150. See supra note 141 and accompanying text.
152. Id. at 158.
154. Rev. Rul. 84-52 at 158.
corporate context, property is defined in section 317 to include almost anything other than an interest in the corporate entity itself.\footnote{155} If the same definition of property applies in the context of section 721, then any conversion and/or exchange of an intrapartnership interest would not be tax-free.

Assuming, arguendo, that this definition does not apply in the context of section 721, then certain additional obstacles must be overcome. For instance, we initially assumed that the ABC partnership had $160,000 of outstanding liabilities and B's outside basis was $30,000. If as a result of the conversion and/or exchange, B's share of liabilities is reduced, section 752(b) provides that such a reduction will be treated as a constructive distribution of money to B.\footnote{156} Accordingly, if the constructive distribution of money is in excess of B's adjusted basis of $30,000, gain would have to be recognized pursuant to section 731(a)(1).\footnote{157} Conversely, if the conversion and/or exchange results in an increase in B's share of liabilities, such increase will be treated as a constructive cash contribution to the partnership, thereby increasing B's basis in his partnership interest under section 752(a).\footnote{158}

\begin{itemize}
\item \textbf{155. Internal Revenue Code § 317(a) provides in relevant part:}
\begin{quote}
PROPERTY — For purposes of this part, the term “property” means money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock).
\end{quote}
\textit{I.R.C. § 317(a) (West 1988).}

\item \textbf{156. Internal Revenue Code § 752(b) provides in relevant part:}
\begin{quote}
DECREASE IN PARTNER'S LIABILITIES — Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.
\end{quote}
\textit{I.R.C. § 752(b) (West 1988).}

\item \textbf{157. Internal Revenue Code § 731(a)(1) provides in relevant part:}
\begin{quote}
(a) PARTNERS — In the case of a distribution by a partnership to a partner — (1) gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution. . . .
\end{quote}
\textit{I.R.C. § 731(a)(1) (West 1988).}

\item \textbf{158. Internal Revenue Code § 752(a)(1) provides in relevant part:}
\begin{quote}
(a) INCREASE IN PARTNER'S LIABILITIES — Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.
\end{quote}
\textit{I.R.C. § 752(a) (West 1988).}
\end{itemize}
B. Contributions and Distributions

This section will deal with the four most common like-kind exchanges in the partnership context: (1) like-kind exchanges preceding a partnership contribution; (2) like-kind exchanges at the partnership level followed by a distribution of the exchanged property to a partner; (3) partnership distributions followed by a subsequent like-kind exchange; and (4) an indirect exchange of partnership interests.

1. Like-Kind Exchanges Preceding a Partnership Contribution

Assume D has a parcel of land with a basis of $20,000, fair market value of $77,500, and mortgage of $40,000, which he would like to contribute to the ABC partnership in exchange for a twenty-five percent interest. Although the partnership is amenable to acquiring another partner, they have no use for raw land in their rental real estate activities. Accordingly, they suggest that D exchange his raw land for a group of townhouses owned by a close and receptive business associate. D effectuates the exchange and then contributes the townhouses to the ABC partnership in return for a twenty-five percent interest.

This type of transaction, a like-kind exchange preceded by a section 721 partnership contribution, should fall within the Magneson line of cases. Recall that Magneson involved a like-kind exchange of a fee simple interest for a ten percent tenancy-in-common interest in another piece of commercial real estate. Simultaneous with that transaction, the taxpayers exchanged their tenancy-in-common interest for a general partnership interest. The Tax Court's holding rested primarily on a continuity-of-investment analysis under regulation section 1.1002-1. Moreover, the Tax Court also applied its standard two prong analysis: first, from an entity approach, were the tenancy-in-common and general partnership interests like-kind property; and second, from an aggregate approach, was the underlying property of like-kind. Re-

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159. See supra notes 82-100 and accompanying text.
161. Id.
162. Magneson, 81 T.C. at 771.
call that the Ninth Circuit found that the first question had to be analyzed under state law.\textsuperscript{164} Since no other circuit has addressed the issue, caution would dictate researching state law prior to engaging in this type of transaction.

From a practical standpoint, however, $D$ may encounter several obstacles notwithstanding state law classifications. First, $D$'s property is encumbered with a $40,000 mortgage and the townhouses, in all likelihood, are also encumbered. To the extent $D$ is relieved of more liabilities than he assumes, the excess is treated as boot requiring $D$'s realized gain to be recognized under section 1031(b).\textsuperscript{168}

In order to avoid similar results, taxpayers have unsuccessfully attempted to adjust the extent to which their properties are encumbered before effectuating a like-kind exchange.\textsuperscript{165} However, in \textit{Long v. Commissioner}, Judge Scott noted that "[a]n agreement to reallocate the liabilities . . . within 6 weeks of . . . [a] like-kind exchange of property, where an excess of liabilities relieved over liabilities assumed constitutes boot . . . clearly raises some suspicions about the intent of the parties."\textsuperscript{167} Judge Scott then found that adjustments to the partnership's profit and loss sharing ratios, which reduced the taxpayer's share of partnership liabilities, were devoid of economic substance and motivated solely by tax avoidance purposes.\textsuperscript{168} She therefore held that the taxpayer's entire

\begin{footnotesize}
\begin{enumerate}
\item \textit{Long}, 77 T.C. at 1077.
\item Id. at 1077-80.
\end{enumerate}
\end{footnotesize}
$853,956 gain realized had to be recognized.\textsuperscript{169}

It should be re-emphasized that Congress's intent behind enacting section 1031(a)(2)(D) was to preclude the tax-free exchange of burnt-out partnership interests and the use of section 754 elections in that regard.\textsuperscript{170} Accordingly, any attempt to have a like-kind exchange between an incoming and exiting partner would fall within the four corners of the statute, i.e. an exchange of property in return for a partnership interest.

2. Like-Kind Exchanges at the Partnership Level Followed by a Distribution of the Exchanged Property to a Partner

It is relatively clear that partners may engage in tax-free\textsuperscript{171} like-kind exchanges among themselves. The more significant issue is what happens once that property leaves partnership solution and winds up in the hands of the individual partners.\textsuperscript{172} When will the partnership's like-kind exchange be considered "old & cold" for purposes of meeting the 1031(a) holding requirement?

In answering this question, the Tax Court's main concern has not been the actual time period that the exchanged property is held, but the intent of the parties at the time the like-kind exchange is effectuated.\textsuperscript{173} If the partnership engages in a like-kind exchange with the intent to distribute such property out to individual partners, the IRS will likely rely on pre-1984 precedent.\textsuperscript{174} Specifically, \textit{Land Dynamics} implies that if the partnership is a dealer in the type of property distributed, it would be very difficult to overcome the factual hurdle of proving that the partnership's

\textsuperscript{169} Id.


\textsuperscript{171} \textit{But see} Internal Revenue Code § 707(b) for rules pertaining to exchanges of property between controlled partnerships.

\textsuperscript{172} One possible alternative is to keep the property in partnership solution and employ the use of "schedular" allocations. For example, have the exchange occur at the partnership level and then specifically allocate the income and expense attributable to the exchanged property to one particular partner. The property itself is never formally distributed out of partnership solution. The problem with schedular allocations is that the IRS can challenge them on the basis that they have caused a constructive division of the partnership. See, e.g., Terence Floyd Cuff, \textit{Planning for Partnership Exchanges Under Section 1031}, 68 Taxes 339, 341-42 (1990).

\textsuperscript{173} See Wagnesen v. Commissioner, 74 T.C. 653, 659 (1980).

\textsuperscript{174} See, e.g., \textit{Land Dynamics} v. Commissioner, 37 T.C.M. (CCH) 1119 (1978).
true intent was not designed as an end run around section 1031(a)(2)(D). If the partnership uses the exchanged property in its trade or business, like in Wagensen, then a subsequent distribution of the property to individual partners may be less susceptible to an IRS challenge.

In Maloney, which involved a corporate distribution, the Tax Court required the shareholder to show that he did not have the intent to liquidate his investment or to use it for personal pursuits. Therefore, from an evidentiary standpoint, if the partnership does not have a business use for the property exchanged, then the partner receiving a distribution of the exchanged property should be able to prove a business use. In fact, even in Gregory v. Helvering, which involved a divisive reorganization, Judge Learned Hand was willing to accept that a spin-off of corporate assets to a newly formed subsidiary could have been supported by a valid business purpose; but, a subsequent distribution of the new subsidiary's stock to the original shareholder was asking the court to exalt form over substance. Likewise, while the IRS normally won't question a like-kind exchange of property among different partners, once that property leaves partnership solution, it may be extremely difficult for the taxpayer to overcome Gregory and its progeny.

From a statutory perspective, assume the ABC partnership exchanges apartment # 2, with a basis of $15,000, fair market value of $75,000 and mortgage of $50,000, for a condominium held by the DEF partnership, with a basis of $20,000, fair market value of $55,000 and mortgage of $30,000. Under section 1001(a) and Tufts, the ABC partnership's amount realized would be $105,000, the fair market value of the property received plus the liability to which the partnership was relieved. Moreover, ABC's gain realized would be $90,000, its amount realized less its adjusted basis in the property transferred. However, this gain realized would only be recognized under section 1031(b) to the extent that the liabilities relieved of are in excess of the liabilities assumed; in this case, $20,000. As previously noted, if ABC tried to pay down its mort-

175. Id.
178. See Gregory v. Helvering, 69 F.2d 809 (2d Cir. 1934).
180. See supra note 165 and accompanying text.
gage on the property, or DEF took on additional debt to avoid section 1031(b), the transaction would be recharacterized to reflect its true substance.\textsuperscript{181} Furthermore, ABC’s adjusted basis in the condominium received would be $65,000, its old basis plus the gain recognized and the additional liability assumed.\textsuperscript{182}

If the condominium received in the exchange and $25,000 in cash were then distributed to B in liquidation of his one-third partnership interest, several consequences would occur. First, gain or loss is normally not recognized on a liquidating distribution of property to a partner.\textsuperscript{183} However, to the extent B receives money, a tier 1 asset, his adjusted basis in his partnership interest must first be reduced to the extent of the cash received.\textsuperscript{184} Therefore B’s adjusted basis in his partnership interest would be reduced from $30,000 to $5,000 as a result of the liquidating cash distribution. Secondly, since the ABC partnership retained its unrealized receivables, no adjustment need be made to B’s basis in his partnership interest resulting from a distribution of tier 2 assets.\textsuperscript{185} Finally, B’s remaining basis in his partnership interest, $5,000, can be allocated in full to the exchanged property, a tier 3 asset, received in liquidation.\textsuperscript{186} However, since the asset distributed to B was encumbered with a $30,000 mortgage, B will be permitted to increase his adjusted basis in the property received from $5,000 to $35,000.\textsuperscript{187}

3. Partnership Distributions Followed by a Subsequent Like-Kind Exchange

The case law that addresses partnership distributions followed by a like-kind exchange is relatively sparse. Mason \textit{v. Commissioner},\textsuperscript{188} which was only a Tax Court memorandum decision, involved the same two partners in two separate partnerships. Each

\textsuperscript{181} See supra notes 166-69 and accompanying text.
\textsuperscript{182} Internal Revenue Code § 1031(d) provides in relevant part:
\hspace{1em} (d) BASIS — If property was acquired on an exchange described in this section . . . then the basis shall be the same as that of the property exchanged . . . increased in the amount of gain . . . recognized on such exchange.
\textsuperscript{184} See Treas. Reg. § 1.732-1(b) (1956).
\textsuperscript{185} See Treas. Reg. § 1.732-1(c) (1956).
\textsuperscript{186} See id.
\textsuperscript{188} 55 T.C.M. (CCH) 1134 (1988).
partnership was liquidated and the assets distributed were subsequently exchanged between the two partners. The Tax Court found that there was a valid section 731 distribution followed by a tax-free like-kind exchange, but for the boot. Interestingly, however, the court failed to address the partner's momentary holding of the property received out of partnership solution or whether or not the step transaction doctrine was applicable.

In Bolker, the Tax Court decided both of these issues in a corporate setting in favor of the taxpayer. The court, relying on Magneson, held that the mere fact that the like-kind exchange was preceded by a section 333 liquidation was insufficient to provide a contrary result. Recall that the Ninth Circuit conveniently avoided the step transaction issue in Bolker; whether other circuits will be so generous is not yet known.

Mason is a prime example of the type of disaster that can occur when a section 731 distribution precedes a like-kind exchange. For instance, in our original example, assume B receives apartment # 1 with a basis of $5,000, fair market value of $60,000 and mortgage of $10,000. Since no cash will be received in liquidation, B will recognize no gain or loss under section 731. However, in a subsequent like-kind exchange of apartment # 1 for suitable replacement property, B could recognize gain under section 1031(b) to the extent he is relieved of a liability in excess of any liabilities assumed. Therefore, B would be well advised to find replacement property which is encumbered with at least $10,000 of indebtedness.

4. An Indirect Exchange of Partnership Interests

A somewhat riskier type of transaction would entail the following steps: 1) a like-kind exchange of property among the ABC and the DEF partnerships under section 1031(a); 2) a liquidating distribution of such property to partner A and partner D (i.e. a 1/3
PARTNERSHIP INTERESTS

partner in each of their respective partnerships) under section 731; and 3) a subsequent contribution of such property by partner A to the DEF partnership and by partner D to the ABC partnership under section 721. After the smoke has cleared, the partners on each side of the initial transaction would have achieved exactly what section 1031(a)(2)(D) was designed to preclude: a direct exchange of partnership interests in different partnerships. This type of exchange would be extremely vulnerable not only under a holding requirement analysis, but also under a step transaction analysis. Specifically, should the IRS collapse the intermediate steps, Gregory and the Court Holding Company decisions would be extremely difficult precedent for the individual partners to overcome.

The partners could argue that the mere fact that a like-kind exchange is either preceded or succeeded by another nonrecognition event is irrelevant to the determination of whether or not a valid section 1031(a) transaction has taken place. On the other hand, the IRS could argue that in addition to a step transaction analysis, the partnerships’ intent, at the time the initial like-kind exchange was effectuated, was not to hold such property for investment or business purposes. Even if these hurdles could be overcome, the partners themselves would have a difficult time proving that their initial intent was not to contribute such property to the transferring partnership. Since this type of transaction is assailable by the IRS on so many different fronts, not to mention the potential liability issues under section 1031(b), it should only be considered after all other possibilities have been exhausted.

C. Joint Venture Interests

In light of section 1031(a)(2)(D), counsel should be exceedingly cautious in the like-kind exchange arena. In the Tax Court’s Magnesen v. Commissioner decision, the majority resolved the issue of whether or not a tenancy-in-common and general partner-

196. Some commentators have suggested that the courts will be reluctant to combine the Magneson and Bolker holdings in light of Congress’s intent behind enacting § 1031(a)(2)(D). See William M. Keating, Congress Eliminated the Like-Kind Exchange of Partnership Interests — Or Did It?, 64 TAXES 573, 583 (1986).
198. See Bolker v. Commissioner, 760 F.2d 1039 (9th Cir. 1985), aff’d 81 T.C. 782 (1983); Wagnesen v. Commissioner, 74 T.C. 653 (1980).
ship interest were of like-kind by referring to regulation section 301.7701.\textsuperscript{199} This regulation provides that tenants in common may be considered partners if they engage in a financial operation or a venture where profits are divided.\textsuperscript{200} For example, "if owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent," then the IRS has the authority to reclassify such an arrangement as a "partnership."\textsuperscript{201}

Accordingly, it would be foolhardy to assume that an exchange of joint venture interests does not fall within the definition of a partnership under section 1031(a)(2)(D) merely because a different label is used to classify such activities. Before property is contributed to a partnership in exchange for a partnership interest, counsel should diligently attempt to uncover the nature and level of business activity taking place with respect to such property. Otherwise, the IRS is likely to assert that what is thought to be a relatively straightforward section 721, 731, or 736 transaction is in fact a taxable exchange of partnership interests under 1031(a)(2)(D).\textsuperscript{202}

V. Conclusion

The IRS has historically scrutinized like-kind exchanges and today has even greater statutory and regulatory precedent to use to invalidate such transactions. As previously noted, the main reason for Congress's enactment of section 1031(a)(2)(D) was to preclude nonrecognition treatment with respect to the exchange of burned-out partnership interests. Accordingly, until the courts define the parameters of section 1031(a)(2)(D), tax planning in the like-kind exchange area should be conservative.

Congress could alleviate a lot of this uncertainty through the introduction of legislation. Specifically, a six-month statutory holding period under section 1031(a) would add stability and cohesiveness to the holding period cases previously discussed. Moreover, Congress could enact clarifying language stating that section 1031(a)(2)(D) was only intended to apply to a direct exchange of

\textsuperscript{199} Magneson v. Commissioner, 81 T.C. 767, 773 (1983).
\textsuperscript{200} Tres. Reg. § 301.7701-3(a) (1960).
\textsuperscript{201} Id.
\textsuperscript{202} But see Steven L. Gleitman & Anatole Klebanow, Restructuring a Partnership as a Tenancy in Common Allows Partners to Make Tax-Free Exchanges of Property, 40 TAX'N FOR ACCT'S 142 (1988).
partnership interests in different partnerships. This would reduce the great uncertainty that surrounds intrapartnership exchanges as well as section 721 or 731 transactions which precede or succeed an exchange of like-kind property.

The Treasury could also promulgate regulations that establish a bright-line test as to what level of business activity is needed before the mere co-ownership of property will be reclassified as a partnership. Respect for our tax laws, and hence compliance, can only be enhanced if taxpayers have some objective criteria against which to measure their affairs. Investors would have a better idea of when the co-ownership of property will be reclassified as a partnership if there was a bright-line rule. For example, the rule could state that reclassification is possible if more than twenty-five percent of a venture’s gross expenditures relate to services. In the alternative, a de minimis rule could be established whereby the co-ownership of rental real estate valued at less than $500,000 would be shielded from reclassification. Either of these rules would be instrumental in adding stability to common real estate transactions.

Finally, since partnership interests are now statutorily unprotected from recognition treatment under section 1031(a)(2)(D), courts need to re-think their approach to indirect exchanges in the context of section 1031(a) and Subchapter K. In brief, the courts will not longer need to look at both the partnership entity and its underlying assets to see whether the provisions of section 1031 have been met. Rather, an aggregate approach similar to section 751 may be more useful in ensuring that an indirect exchange of partnership property does not escape the boot recognition rules of 1031(b).