"IRC Section 1031 and Real Estate: Tenants In Common and Dissentient Partners"

Thomas R. Popplewell

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Thomas R. Popplewell is a tax lawyer and partner of the Dallas office of Houston's Andrews & Kurth. His e-mail address is tpopplewell@akllp.com. The views represented here are his own and do not represent those of the firm.

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In applying applicable sections of the Internal Revenue Code of 1986[1] to a set of facts[2], one must determine who the taxpayer is. Generally, this is not much of an issue. However, in dealing with the application of Section 1031[3] to property that is owned by multiple owners as tenants-in-common, the law is at best murky. One principal issue involves whether each co-owner is a separate taxpayer or whether the co-owners have formed a partnership for federal income tax purposes that is the taxpayer. If a partnership exists between the co-owners for federal income tax purposes, then the partnership must satisfy the requirements of Section 1031(a) to obtain its benefits.[4] If no partnership exists, each co-owner may satisfy the conditions under Section 1031 separately.

Making the correct determination as to whether a partnership exists for federal income tax purposes is particularly important since the 1984 amendment of Section 1031 to provide that interests in a partnership do not qualify for like kind treatment under Section 1031.[5] Furthermore, if a partnership exists and some of the partners want to apply Section 1031 and others (the "dissentient ones") do not, achieving the desired result without adverse income tax consequences involves significant challenges.

Situations In Which the Issues Might Arise

Typical situations in which the issues discussed in this article arise will usually conform to one of the following:

Situation 1: Property held as tenants in common is exchanged for like kind property held as tenants in common.

Situation 2: Property wholly owned by one person is exchanged for like kind property held as a tenant in common with others.

Situation 3: The owners of property held as tenants in common each exchange their interests for a like kind property wholly owned by each former tenant in common.

Situation 4: In a partnership that disposes of property, one or more partners desire to exchange the property for like kind property while the remaining partner or partners desire to obtain cash.

Situation 5: This is similar to Situation 4 but the dissentient partner or partners want to reinvest in a different property or properties.

The following issues are some that may arise in these situations. In each case, we assume that the underlying properties are of a "like kind."[6]

Situation 1 probably involves the least risk, if any. If the tenants in common have not formed a partnership for federal income tax purposes (a "tax partnership") and if each tenant satisfies the requirements of Section 1031(a), its benefits are automatic.[7] Also, if a tax partnership has been formed (unknowingly), but all the co-owners have satisfied the requirements of Section 1031(a), its benefits will almost certainly inure to the co-owners. While there are reporting requirements for exchanges subject to Section 1031,[8] it is unlikely that, if a tax partnership had been formed, but each co-owner properly reported the exchange, that the IRS would assert any penalties. Quite simply, the government has suffered no harm.

In Situation 2, if the second property is treated as an interest in a co-tenancy and not as a tax partnership, then, assuming the other requirements of Section 1031(a) are satisfied, the exchange qualifies as a "like kind" exchange under Section 1031. However, if the co-tenancy is actually a tax partnership then the taxpayer has attempted to exchange fee property for an interest in a partnership. This exchange does not qualify for treatment under Section 1031 because the two properties are not of a "like kind."9 Thus, it is imperative that the taxpayer know whether the interest in the co-tenancy will actually be treated as a tax partnership.

Situation 3 presents the same issues a Situation 2, only in reverse. Here, the taxpayers/co-owners must be certain that the first property is not held in a tax partnership.

In Situation 4, the existence of a tax partnership is given. As discussed below, the issues involve how may the partners and the partnership allocate the taxable income or loss to the dissentient partners so that the tax effects of the transaction match the intended economic results. Or are there other alternatives?

Situation 5 may present a combination of several of the above issues.

Differentiating Between a Tax Partnership and a True Tenancy in Common

Unfortunately for taxpayers and their advisers, the determination of whether a tenancy in common is actually a tax partnership is not often easy.10 For federal income tax purposes, the Internal Revenue Code of 1986 provides that the "term '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, within the meaning of this title, a corporation or a trust or estate."11

An "organization" can be treated as a separate entity taxable as a partnership notwithstanding that it is not a partnership under any state law.12 The regulations provide only limited assistance:

(2) Certain joint undertakings give rise to entities for federal tax purposes. A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits there from. For example, a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent. Nevertheless, a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes. For example, if two or more persons jointly construct a ditch merely to drain surface water from their properties, they have not created a separate entity for federal tax purposes. Similarly, mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a separate entity for federal tax purposes.13

As we shall see, the determination of what services may be provided to occupants of leased premises before converting *mere* co-ownership into a partnership is not easily determined.

Since 1949, the courts following the direction of the Supreme Court have used the intent of the parties to the arrangement or relationship as the most important determinant as whether a tax partnership has been established. In *Commission v. Culbertson*,14 the Supreme Court held that a tax partnership exists only if: considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.15Note very carefully that the question is not "Did the parties intend to form a tax partnership?" Instead, the proper focus must be "Did the parties intend to jointly conduct a business enterprise?" If the answer is in the affirmative, then a tax partnership has been formed.

Notwithstanding the Supreme Court's "all the facts and circumstances" test, the Tax Court in *Hubert M. Luna v. Commissioner*,16 has, after citing *Culbertson*17 set forth certain criteria for helping to determine whether a tax partnership is formed:

1. the agreement of the parties and their conduct in executing its terms;
2. the contributions, if any, which each party has made to the venture;
3. the parties' control over income and capital and the right of each to make withdrawals;
4. whether each party was a principal and co-proprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income;
5. whether business was conducted in the joint names of the parties;
6. whether the parties filed Federal partnership returns or otherwise represented to respondent or to persons with whom they dealt that they were joint venturers;
7. whether separate books of account were maintained for the venture; and
8. whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.18

In the case of co-owned property, many of the *Luna* factors are essentially automatically obtained. Each party has made a contribution to acquire its interest. Subject to any agreement between them, each party has control over income. Each is a co-proprietor having a share in profits and losses. Based on these factors it is easy to conclude that if co-owners call themselves partners they are almost always tax partners.19

Probably the most direct public analysis of the applicable regulations by the IRS is in Revenue Ruling 75-374.20 Two corporations each owned an undivided one-half interest in an apartment project. They hired a management company "to manage, operate, maintain, and service the project."21 The management company negotiated and executed leases, collected rents, paid taxes and insurance and performed "all other services customarily performed in connection with the maintenance and repair of an apartment project."22 These "customary services" were furnished at no additional charge over basic rents, were reimbursed by the owners and consisted of heat, air conditioning, hot and cold water, unattended parking, normal repairs, trash removal and cleaning of public areas. The management company was paid an amount based on gross rentals. The management company also provided at its own cost additional services, such as attendant parking, cabanas, and gas, electricity and other utilities. The management company retained all profit earned on these additional services. The IRS held that no tax partnership existed between the two owners because they did not provide services to the occupants either directly or through an agent. The services the owners provided were "customary services." The other services were provided by the management company at its own risk and not as an agent for the owners.23

Several cases have considered similar factual situations. In *Estate of Levine v. Commissioner,*24 contrary to the taxpayer's urgings, the Tax Court found a tax partnership existed notwithstanding the parties' lack of such characterization of their relationship. This was based on its finding that the co-owners engaged in the active conduct of a trade or business because they "furnished property management services to the tenants"25 of the properties and "performed various services, and shared the gains and losses."26

In *Demirjian v. Commissioner*,27 a case dealing with replacement properties under Section 1033, the Tax Court found a tax partnership existed where the taxpayer again denied its existence. Based upon the facts, the court found the *intent* to form a partnership. The parties used a trade name, were deeded the property as "partners trading as Kin-Bro Real Estate Company,"28 reported their activities on federal partnership tax returns and provided some services to tenants, although the services were only basic light, water and heat.

In *George Rothenburg v. Commissioner*,29 the taxpayers had filed partnership tax returns and operated under a trade name. The court, noting "the amount and types of expenses claimed by the partnership in its return indicate that the operation constituted the active conduct of a rental business,"30 stated where co-owners relinquish some of their legal

rights to deal with their interest in the property or allow management or sale of the property without unanimous agreement of the co-owners, a tax partnership is often found to exist.31

Nevertheless, the Tax Court clearly acknowledges that co-owners who rent their property are not ipso facto partners for tax purposes. In *McShain v. Commissioner*,32 the court found that where two co-owners net leased land to a corporation that built a building on it, no tax partnership had been formed. Title to the land had been taken as co-owners and the net lease did not require the co-owners to provide services. The taxpayer, one of the co-owners, asserted that a tax partnership had been formed to void a Section 1033 election he had made individually. In *Estate of Appleby v. Commissioner*,33 two brothers inherited real property and held it as co-owners. They separately negotiated leases, separately paid insurance and provided no services with respect to the property. The court found no tax partnership existed. Similarly, in *Hahn v. Commissioner*,34 two sisters, owning an inherited apartment dwelling as co-owners, were found not to have formed a tax partnership.

In conclusion, it should be apparent that for co-owners of real property not to be treated as a partnership, great care must be taken and much restraint must be exhibited. The parties should attempt to do as many of the following as possible:

1. Do not use a joint bank account.
2. If a manager is used, severely restrict his authority to the most ministerial duties and do not have a contract with a term over one year.
3. Do not provide any services to the occupants of leased property other than those services described in Revenue Ruling 75-374.
4. Do not use a trade name.
5. Do not restrict disposition of a co-owner's undivided interest.
6. Require unanimous consent to sell the property and, if possible, lease the property.
7. Use triple net leases.
8. Each co-owner should pay his or her own share of expenses separately.
9. Each co-owner should insure his or her interest separately.
10. Do not file a partnership tax return.
11. Never express any intention of being partners.

The IRS has very recently issued Revenue Procedure 2000-46,35 adding the following two areas to those in which it will not issue advance rulings or determination letters:

Section 1031. - Exceptions. - Whether an undivided fractional interest in real property is an interest in an entity that is not eligible for tax-free exchange under Section 1031(a)(1).

Section 7701. - Definitions. - Whether arrangements where taxpayers acquire undivided fractional interests in real property constitute separate entities for federal tax purposes.36

Apparently, the IRS is concerned that some taxpayers are taking what it considers inappropriate positions with respect to co-owned property. In this Revenue Procedure the IRS noted it recently has become aware, in part through several requests for advance rulings, that taxpayers are taking the position that certain arrangements where taxpayers acquire undivided fractional interests in real property do not constitute separate entities for federal tax purposes and therefore the fractional interests may be the subject of tax-free exchanges under Section 1031(a)(1). The IRS reported that it intends to further study the facts and circumstances relevant to the determination of whether such arrangements are separate entities for federal tax purposes.

Finally, the IRS requested comments:

with respect to the relevance and impact of the following factors to the determination of whether arrangements where taxpayers acquire undivided fractional interests in real property constitute separate entities for federal tax purposes: (1) the terms of any leasing or management agreements entered into with respect to the property and the relationships between the parties to such agreements and the promoter or organizer of the arrangement; (2) the terms of any agreements between the promoter or organizer of the arrangement and the holders of the fractional interests or among the holders of the fractional interests, including any contractual restrictions to which the fractional interests are subject, such as waivers of the right to partition, rights of first refusal, and options to put and/or call the fractional interests; and (3) the overall economics of the arrangements, including the sharing of profits and losses from operating the property as well as of appreciation and depreciation in the value of the property.[37]

“Electing Out” of Subchapter K

In 1990, Section 1031 was amended[38] to provide that “an interest in a partnership which has in effect a valid election under Section 761(a) to be excluded from the application of all of subchapter K shall be treated as an interest in each of the assets of such partnership and not an interest in a partnership.”[39] While this seems to be the answer for those yearning to hold their property as tenants in common but deal with each interest independently for various tax purposes, including Section 1031, it appears that its utility is very limited, especially when real property is involved. The reason lies in the restrictions set forth in Section 761 and the related regulations. Section 761 limits the election to organizations which are availed of

1. for investment purposes only and not the active conduct of a business,
2. for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted, or
3. by dealers in securities for a short period for the purpose of underwriting, selling, or distribution of a particular issue of securities, if the income of the members of the organization may be adequately determined without the computation of partnership income.[40] The regulations provide that with regard to *investing partnerships:*

Where the participants in the joint purchase, retention, sale, or exchange of investment property—

1. Own the property as co-owners,
2. Reserve the right separately to take 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, although each separate participant may delegate authority to purchase, sell, or exchange his share of any such investment property for the time being for his account, but not for a period of more than a year, then such group may be excluded from the application of the provisions of subchapter K.[41]

Thus any real estate partnership must satisfy these three requirements to elect out of the provisions of subchapter K under Section 761(a). First, its property may not be owned by the partnership but must be in the names of the partners. The application of the second requirement above in the context of rental real estate is not clear. Perhaps it can be satisfied by each partner’s having the right to sell its interest separately. However, even this right is often not looked upon favorably by co-owners. As to the last requirement, clearly any manager of the property must not have a contract exceeding one year. As discussed above, however, the prohibition from actively conducting a business, which actually appears to be a separate requirement and is a statutory requirement, is very problematical in the operation of real estate. A close inspection of these requirements leads to the conclusion that if co-owners satisfy these rigorous requirements and do not intend to form a partnership they will not likely be a tax partnership even without making the election under Section 761(a). Nevertheless, if co-owners satisfy these requirements but do hold themselves out as partners or have other attributes of partners, an election may produce the desired result.[42] However, if the partnership is *operating a business*, election out is not possible.[43] Probably the most important determinant as to whether a business is “operated” is the degree, amount and type of services provided by the owners.[44]

Dealing With The Dissentient Partner

In the following discussion, we assume that Situation 4 exists; i.e., that the relinquished property is held by a tax partnership. We also assume that one or more partners wants to receive cash from the disposition of the partnership's property, but the remaining partners desire to exchange the property for "like kind" property so that Section 1031(a) applies. To analyze the tax aspects of Situation 4 consider the following example. DP1, DP2, EG1 and EG2 each own 25% of a limited liability company that is a tax partnership which owns a recently improved tract of land. DP1 recently purchased his interest in the partnership from a former partner for $1 million and immediately thereafter DP2 contributed $1 million to the partnership for his interest which was used to construct improvements to the property. The partnership made an election under Section 754 to increase the basis of the partnership's assets to $2 million and increased the partners' capital accounts to $4 million to reflect a revaluation of the property.45 For simplicity, assume that EG1 and EG2 have no basis in their partnership interests. The partnership is now selling the property for $4 million. DP1 has changed his investment strategy and wants to "cash out." DP2 also wants to cash out. EG1 and EG2 each want to reinvest the proceeds in like kind property. If the partnership uses a deferred exchange,46 deposits $2 million with a qualified intermediary,47 and receives $2 million in cash to be distributed to DP1 and DP2, the partnership will have a $2 million gain.48 If the gain is allocated 25 % to each partner, EG1 and EG2 will clearly not be happy. What are the possible solutions?

Special Allocation of Gain. A tax practitioner's first thought is probably to specially allocate $1 million of the gain to each of DP1 and DP2. There would be no effect to the capital accounts which had been revalued to $1 million each. Neither DP1 nor DP2 would have economic gain or loss. However, DP1 and DP2 would each increase the basis in their capital accounts to $2 million but would receive only $1 million in liquidation of their respective partnership interests. This would result in a $1 million gain and $1 million capital loss to each which would not necessarily offset one another if any of the gain on the sale of the property was ordinary income, e.g., it was due to depreciation recapture. However, this allocation of gain (even if it is acceptable to the partners receiving it because it is all capital gain) does not satisfy the requirements of Section 704(b).49 Under Section 704(b) and the related regulations, the $2 million gain must be allocated equally to EG1 and EG2, which will not be acceptable to them.50 Thus, in many cases the gain cannot be specially allocated to achieve the desired results.

Distribution of an Interest in the Property to DP1 and DP2. DP1 and DP2 want to cash out of their investment. If the gain cannot be specially allocated to the partners taking the cash distributions, some tax practitioners have suggested that a solution is to distribute the property to the partners who then make the disposition individually. There are two variations. In the first, the partnership distributes a 25% undivided interest to each of DP1 and DP2 so that DP1, DP2 and the partnership own the property as tenants in common. In the second, the partnership distributes a 25% interest in the property to each partner. Each of these alternatives has risks, with the second having more risks.

The principal risks arise from these two questions:

1. Even though a legal distribution of property has been made in each case, is there still a tax partnership between the co-owners? This is the same issue as discussed above under *Differentiating Between a Tax Partnership and a True Tenancy in Common*. If there is still a tax partnership nothing has been achieved by the distribution.
2. In each case, as to the partners who receive a property distribution, assuming the property is immediately disposed of as the first step of an exchange, has each partner held the property "for productive use in a trade or business or for investment"51 as required to satisfy the requirements of Section 1031(a)?

In *Mason v. Commissioner*,52 the taxpayer had been in a two person partnership. After a disagreement, the parties separated and exchanged the "undivided interest in the jointly owned real property"53 pursuant to a "Sales Contract." The issue before the court was whether the two partners exchanged partnership interests or whether the partnership was liquidated and undivided interests were conveyed. The court held that the partnership had been liquidated and immediately thereafter the exchanges of undivided interests took place; thus, a Section 1031 exchange took place. However, even though the facts in the case frame the issue very well little comfort can probably be taken from this holding because neither the IRS nor the court addressed the issue of whether the "held for" standard was satisfied.54 Furthermore, the case was decided before the 1984 amendment to Section 1031 eliminating tax free exchanges for partnership interests.

In *Bolker v. Commissioner*,55 the taxpayer owned a corporation holding real estate. He liquidated the corporation and on the same date contracted to exchange property received in the liquidation for like kind property. The closing occurred three months later. The IRS argued that Bolker did not hold the exchanged property "for productive use in trade or business or for investment."56 The IRS asserted that Bolker acquired the exchange property with the intent, and almost immediate contractual obligation, to exchange it, and, hence, Bolker never met the "held for" requirement of Section 1031. The court formulated the IRS's position as requiring that the following two elements be established to satisfy the holding requirement: "that the taxpayer own the property to make money rather than for personal reasons, and that at some point before the taxpayer decides to exchange the property, to have intended to keep that property as an investment."57 To the contrary, Bolker argued that the holding requirement was satisfied because he had the intent to exchange investment property for other investment property. Again the court formulated this position as having two elements: "that the taxpayer own the property to make money, and that the taxpayer not intend to liquidate his investment."58 Even though the court noted that revenue rulings are not controlling, the court distinguished the *Bolker* facts from those in Revenue Ruling 77-33759 which held that, where pursuant to a prearranged plan, a corporation was liquidated and the shopping center received was exchanged, Section 1031(a) did not apply. The court noted that Bolker planned the liquidation before any intention to exchange the properties arose, and Bolker actually held the property for three months.60 The *Bolker* court found some comfort from *124 Front Street, Inc. v. Commissioner*,61 in which the court held a Section 1031 exchange occurred where the purchaser advanced funds for the taxpayer to exercise an option to acquire property and contractually agreed to exchange it. The purchaser found property satisfactory to the taxpayer and the exchange occurred five months later. Although the *Front Street* court did not examine the "held for" issue, the *Bolker* court found that the case supported Bolker's theory that an intent to exchange for like kind property is sufficient.

The Tax Court's holding in *Bolker* was based on its opinion in *Magneson v. Commissioner*.62 In *Magneson*, the taxpayer exchanged investment property for like kind property, and then by prearrangement, contributed the replacement property to a general partnership. In the words of the *Bolker* court, "The *Bolker* Tax Court interpreted *Magneson* as holding that an intent to continue the investment rather than selling it or converting it to personal use satisfied the holding requirement, even if the taxpayer never intended to keep the specific property acquired."63 The *Bolker* court noted that it affirmed *Magneson* on different grounds: "that the Magnesons intended to and did continue to hold the acquired property, the contribution to the partnership being a change in the form of ownership rather than the relinquishment of ownership."64 Thus the court concluded that nothing in *Magneson* relieved Bolker from having to satisfy the requirement that he hold the property exchanged for investment.

The *Bolker* court held that, based on the ordinary meanings of the words in the statute, Section 1031(a) requires that the "holding" requirement is satisfied by "owning the property"65 and the "for productive use in trade or business or for investment" requirement is satisfied by "lack of intent either to liquidate the investment or to use it for personal pursuits."66 The court declined to add the requirement that before forming the intent to exchange the property, the taxpayer must have an intent to keep it indefinitely.67 Thus Bolker satisfied the requirements of Section 1031(a) because his "intent to exchange property for like kind property satisfies the holding requirement, because it is *not* an intent to liquidate the investment or to use it for personal pursuits."68

Based solely upon the holding in *Bolker*, DP1 and DP2 should satisfy the "held for" requirement of Section 1031(a) because each has the intent to exchange the property for like kind property and no intent to liquidate it or use it for personal pursuits. Nevertheless, the IRS and a court, if predisposed to do so, could, notwithstanding the seemingly straightforward conclusion in *Bolker*, distinguish it. For example, in *Bolker* the court noted that the corporate liquidation was planned before any intention to exchange the property arose and Bolker actually held it for three months. It is interesting to note that under the holding in *Bolker* the taxpayer in Revenue Ruling 77-337 would have satisfied the requirements of Section 1031(a). Nevertheless, the court obviously felt some compulsion to distinguish the facts in *Bolker* from those in Revenue Ruling 77-337. The facts in our example are almost identical to those in Revenue Ruling 77-337. In addition, *Magneson* was decided before Section 1031(a) was amended to eliminate tax-free exchanges of partnership interests. One could also distinguish our fact situation from *Magneson* because our partners hold a position in a limited liability tax partnership and not a general partnership so that the "form of ownership" is more dissimilar.

*Crenshaw v. U.S.*69 is an example of the risks involved in this type of situation if the distributed property finds its way back to the partner. The taxpayer in *Crenshaw* owned a 50/255 interest in an apartment partnership. The other partners wanted to buy her interest but she wanted a Section 1031 exchange. She had the partnership distribute an undivided interest in the apartments to her. She exchanged this with her husbands' estate for other real estate. The estate sold the undivided interest to a corporation owned by her former partners who caused the corporation to contribute it back to the partnership. Relying on the substance-over-form doctrine, the court disregarded the transfer of the interest in the apartments to the taxpayer and concluded that the series of transfers resulted in a sale by the taxpayer of her interest in the partnership.70 As in *Court Holding v. U.S.,*71 the court reasoned that the tax consequences of an interrelated series of transactions could not be determined by viewing each in isolation. Instead, the transactions had to be considered together as component parts of an overall plan.72

The court found the last step in the series of transactions key to its finding that a sale rather than a liquidation had occurred. The fact that the taxpayer's 50/255 interest in the apartments ultimately found its way back into the partnership in exchange for the partnership interest formerly owned by the taxpayer precluded a finding that the taxpayer's interest in the partnership was liquidated.73

Purchase of Interests of Cashed Out Partners. One possible solution, particularly where the dissentient partners' interests are relatively small, is for the partnership to borrow money or obtain money from the remaining partners and purchase the partnership interest of the dissentient partners. Clearly, this will change the economics to the partnership, but it does not have the tax risks other alternatives have.

Use of Installment Notes. Under this "solution," in the disposition of the property the partnership accepts $2 million in cash which is deposited with the qualified intermediary and two $1 million installment notes which are distributed, one to DP1 and one to DP2. The notes provide for a very high percentage of the principal payments due shortly after closing and the remaining payment due after the end of the taxable year.74 Depending upon the credit worthiness of the buyer, the installment note may be secured by assets qualifying under the applicable Treasury regulations.75 Obviously, the buyer must be accommodating. The partnership, then having only EG1 and EG2 as partners will cause the qualified intermediary to complete the tax-free exchange. Because the partnership receives an installment note it does not recognize gain upon its receipt. The distribution of the installment notes to DP1 and DP2 is not a taxable event to either the partnership, DP1 or DP2.76

Situation 5. In Situation 5 DP1 and DP2 want to reinvest into property different than that reinvested into by the partnership. There are at least three possible solutions. First, the partnership could distribute undivided shares of its property to DP1 and DP2 who could make their own exchanges when the partnership makes its exchange. This has the same risks as discussed above if the tax partnership continues. Also, in the case where DP1 and DP2 do not have a fair market value basis then there is the same question discussed above as to whether DP1 and DP2 have satisfied the "held for" requirement. Under *Bolker*, they have, but under Revenue Ruling 77-337 they have not.

Second, the partnership could make all the exchanges and then distribute to the dissentient partners the properties each desires. In this case, the question is whether the partnership has satisfied the "held for" requirement of Section 1031(a) as to the distributed properties. This issue is the reverse of the one in *Magneson* but the same reasoning and risks previously discussed should apply.

Third, the partnership could make all the exchanges. The partnership agreement could be amended to provide that DP1 and DP2 share 98% in their respective property or properties and EG1 and EG2 share 1% each in such property. The reverse percentages would apply as to the other property. In this case, the partnership is preserved as to each partner. At some future indefinite time the partnership could distribute the properties to DP1 and DP2 as above. This definitely seems to be the safest of the three approaches. During the combined ownership periods the partnership could own each property in a separate limited liability company and specify different managers, if desired, for each. Under the "check the box" regulations,77 the limited liability companies are disregarded.78

How Not To Do It

For an example of what *not* to do, one must go no further than the facts of Technical Advice Memorandum 199907029 (Sept. 30, 1998) ("Memorandum"). The Memorandum concerns the application of Section 1033 and Section 1031, but the lessons to be learned are equally relevant to each section. The conclusions of the Memorandum are probably an indication of a "kinder and gentler" IRS because the taxpayers could have suffered much worse.

According to the Memorandum, A "pooled" property with cash advanced by B and C, with B and C each receiving undivided interests in the property. An apartment building was constructed using proceeds of a loan obtained in the individuals' names. The improvements were insured in the names of A, B and C, but the property was operated under the trade name "Real Estate Venture."[79] A U.S. partnership tax return (Form 1065) was filed each year for *23 years*. The property and improvements were listed as assets in the tax return and deductions were taken for interest, taxes and depreciation. Rents were deposited in a bank account opened in the name of Real Estate Venture and expenses were paid from the account. A partnership agreement was entered into by A, B and C. The partnership agreement contained various typical real estate partnership provisions including:

- A purpose to construct and operate an apartment house.
- Capital contributions, including A's land.
- profits and losses to be allocated in accordance with ownership percentages.
- Management to rest with B.

Notwithstanding all of this, the taxpayers asserted that they only entered into the partnership agreement to construct and operate the apartment house but never intended to transfer any property to the partnership and had not formed a tax partnership.

The apartment house was destroyed by a natural disaster and after collecting the proceeds, A, B and C determined they could not repair the building. A and B used the proceeds to purchase property 2 intending to qualify under Section 1033.

A and B then tried to exchange property 1 for property 3 intending a tax-free exchange under Section 1031. A, B and C each signed exchange agreements with an accommodator who sold property 1 and deposited the cash in separate "exchange accounts" for A, B and C. The accommodator acquired property 3 and transferred undivided interests to A and B. No facts were available as to what C did with the proceeds from property 1 or the insurance proceeds.

The IRS determined that, based on the facts, A, B and C had formed a tax partnership and that the apartment house and property 1 were its assets. The nonrecognition of gain election under Section 1033 and replacement of the converted property must be done by the partnership.[80] The IRS determined that C redeemed his interest but that the AB tax partnership was a continuation of the ABC tax partnership and the partnership was entitled to deferral of gain on the apartment house under Section 1033.

The IRS also concluded that even though the ABC partnership had not entered into a written exchange agreement with the accommodation party as required under the applicable Section 1031 regulations,[81] it graciously considered the individual agreements with A, B and C as having the effect of an agreement with the partnership. Furthermore, although the receipt by C of cash proceeds of the sale caused the exchange agreement to violate the regulations,[82] the IRS held that the individual exchange accounts were qualified escrow accounts and only as to C did the partnership actually or constructively receive money in violation of the regulations.[83] Based on this, the IRS held that the exchange qualified under Section 1031, but that the ABC partnership recognized gain not to exceed the cash received by C. No allocation of the gain among the partners was made or discussed. If the IRS agent on the case allocated this to C the taxpayers A and B should still be counting their lucky stars.

Conclusion

The rules regarding the application of Section 1031(a) to properties held as tenants-in-common are complex and unsettled, especially when the uncertainty of whether a tax partnership has, often unknowingly, been found. Tax advisors have several methods to deal with most of the issues raised but taxpayers should be aware that risks as to the proper tax treatment may exist even under what may appear the most conservatively designed plan.

1 Unless otherwise noted, all section references are to the Internal Revenue Code of 1986.

2 Hopefully, some of the readers are old enough to remember the television character, Sergeant Joe Friday and his line: “Just the facts, ma’am.” Query: Why do so many taxpayers, and even their non-tax oriented advisers, underestimate the relevance of knowing the precise facts to properly apply the tax laws to a transaction?

3 I.R.C. § 1031(a) NONRECOGNITION OF GAIN OR LOSS FROM EXCHANGES SOLELY IN KIND.—

1 IN GENERAL.— No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.

2 EXCEPTION.—This subsection shall not apply to any exchange of—

1 stock in trade or other property held primarily for sale,
2 stocks, bonds, or notes,
3 other securities or evidences of indebtedness or interest,
4 interests in a partnership,
5 certificates of trust or beneficial interests, or
6 choses in action.

For purposes of this section, an interest in a partnership which has in effect a valid election under Section 761(a) to be excluded from the application of all of subchapter K shall be treated as an interest in each of the assets of such partnership and not as an interest in a partnership.

3 REQUIREMENT THAT PROPERTY BE IDENTIFIED AND THAT EXCHANGE BE COMPLETED NOT MORE THAN 180 DAYS AFTER TRANSFER OF EXCHANGED PROPERTY.—For purposes of this subsection, any property received by the taxpayer shall be treated as property which is not like-kind property if—

1 such property is not identified as property to be received in the exchange on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange, or
2 such property is received after the earlier of—

1 the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or
2 the due date (determined with regard to extension) for the transferor’s return of the tax imposed by this chapter for the taxable year in which the transfer of the relinquished property occurs.

I.R.C. § 1031(a).

4 Note, however, that Section 1031 defers gains *and losses.*

5 The Tax Reform Act of 1984 added Section 1031(a)(2)(D) which provides that Section 1031(a) does not apply to any exchange of “interests in a partnership.” *See* Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984).

6 I.R.C. § 1031(a)(1).

7 The application of Section 1031 is not elective.

8 *See* IRS Schedule D, Form 4797 and Form 8824 and their respective instructions.

9 Treas. Reg. § 1.1031(a)-1(b) (as amended 1991).

10 On the other hand, if taxpayers have intended to form a tax partnership and have a partnership agreement, file partnership tax returns and generally otherwise "quack" like a tax partnership "duck", it is inconceivable that the IRS would ever assert that the taxpayers were merely co-owners.

11 I.R.C. § 761(a). A virtually identical definition is given in Section 7701(a)(2).

12 *See* Treas. Reg. § 301.7701-1(a)(1) (as amended 1997).

13 *Id*. at § 301.7701-1(a)(2). For crop share cases see *White's Iowa Manual Labor Inst. v. Commissioner*, 66 T.C.M. (CCH) 389 (1993) and *Emily Oblinger Trust v. Commissioner*, 100 T.C. 114 (1993).

14 337 U.S. 733 (1949).

15 *Id*. at 742-43.

16 42 T.C. 1067 (1964).

17 *Id*. at 1077.

18 *Id*. at 1077-78.

19 *See Chisolm v. Commissioner*, 79 F.2d 14 (2d Cir.), *cert.denied*, 296 U.S. 641 (1935). In *Chisolm*, brothers formed a partnership with co-owned property very shortly before a sale of stock which gained them significant tax advantages. Notwithstanding the obvious tax advantages, the court found a tax partnership was formed. The court noted that formation of a partnership had been discussed for six or eight months before the sale and that the partnership continued through to the date of the case, a period of several years.

20 1975-2 C.B. 261.

21 *Id.*

22 *Id.*

23 *See id.*

24 72 T.C. 780 (1979), *aff'd*, 634 F.2d 12 (2d Cir. 1980).

25 72 T.C. at 785.

26 *Id.*

27 54 T.C. 1691 (1970), *aff'd*, 457 F.2d 1 (3rd Cir. 1972).

28 54 T.C. at 1996.

29 48 T.C. 369 (1967).

30 *Id*. at 373.

31 *See Bussing v. Commissioner*, 88 T.C. 449 (1987), *reconsideration denied by 89* T.C. 1050 (1987) (finding a tax partnership existed between co-owners of computer equipment in a tax shelter case where the co-owners each executed agreements granting a third party full rights to dispose of the property without unanimous agreement of the co-owners); *Bergford v. Commissioner*, 12 F.3d 166 (9th Cir. 1993) (holding tax partnership existed in tax shelter computer case where 28 taxpayers' abilities to partition the property were illusory, and their economic benefits were found to be not derivative of

their co-ownership of computer equipment but from their joint relationship toward a common goal). *Compare Levy v. Commissioner*, 91 T.C. 838 (1988)(finding taxpayers had a unilateral right to terminate the management agreement).

32 68 T.C. 154 (1977).

33 41 B.T.A. 18 (1940), *acq. in part, not acq. in part*, 1940-2 C.B. 1, *aff'd*, 123 F.2d 700 (2d Cir. 1941).

34 22 T.C. 212 (1954).

35 Rev. Proc. 2000-46, 2000-44 I.R.B. 438.

36 *Id.*

37 *Id.*

38 *See* Omnibus Budget Reconciliation Act of 1990, P.L. 101-508, 104 Stat. 1388, § 11703(d)(1990).

39 I.R.C. § 1031(a).

40 I.R.C. § 761.

41 Treas. Reg. § 1.761-2(a)(2) (as amended 1995).

42 There is some concern that a partnership that makes an election under Section 761(a) may still be a partnership for purposes of the Code outside of subchapter K. *See, e.g., Madison Gas & Elec. Co. v. Commissioner, 72* T.C. 521 (1979), *aff'd*, 633 F.2d 512 (7th Cir. 1980) (finding a valid election under Section 761(a) did not prevent the arrangement from being treated as a partnership for purposes of Section 162 in determining deductibility of preoperating expenses). *Bryant v. Commissioner*, 399 F.2d 800 (5th Cir. 1968), *aff'g* 46 T.C. 848 (1966); Rev. Rul. 65-118, 1965-1 C.B. 30. For a history and an analysis of the Section 761(a) election by the IRS see Tech. Adv. Mem. 9214011 (Dec. 26, 1991).

43 Field Service Advice 199923017 (Mar. 5, 1999).

44 *See supra* text accompanying notes 20-34.

45 *See* Treas. Reg. § 1.704-1(b)(2)(iv)(f) (as amended 1997).

46 *See* I.R.C. § 1031(a)(3).

47 *See* Treas. Reg. § 1.703-1(k)-1(g)(4) (as amended 1991).

48 Section 1031(b) requires gain to be recognized in an amount equal to the lesser of (i) the gain realized and (ii) the cash and other non-like kind property received.

49 The capital accounts were originally revalued under Treasury Regulation § 1.704-1(b)(2)(iv)(g). Treasury Regulation § 1.704-1(b)(2)(iv)(f)(3) requires that the capital accounts be adjusted in accordance with Treasury Regulation § 1.704-1(b)(2)(iv)(g) for allocations of gain or loss computed for book purposes. Because the gain for book purposes is zero, no allocation is made to the capital accounts. Thus, the allocation of the taxable gain cannot have substantial economic effect because it is not reflected in the capital accounts. In this case, Treasury Regulation § 1.704-1(b)(4)(i) requires that the gain must be allocated "in a manner that takes account of the variation between the adjusted tax basis of such property and its book value in the same manner as variations between the adjusted tax basis and the fair market value of property contributed to the partnership are taken into account in determining the partners' shares of tax items under Section 704(c)." The effect of this is that the gain must be allocated $1 million each to EG1 and EG2. *See also* Treas. Reg. § 1.704-1(b)(4) Ex. 14.

50 Note that because the property was revalued for book purposes, there is no difference in analysis between DP1, whose pre-revaluation capital account may have been less than $1 million, and DP2, whose pre-revaluation capital account was equal to his post-revaluation capital account.

51 I.R.C. § 1031(a)(1).

52 55 T.C.M. (CCH) 1134 (1988).

53 *Id.* at 1135.

54 Also, neither considered whether the liquidation terminated the tax partnership or only the state law partnership.

55 760 F.2d 1039 (9th Cir., 1985), *aff'g* 81 T.C. 782 (1983).

56 760 F.2d at 1041.

57 *Id.* at 1042-43.

58 *Id.* at 1043.

59 1977-2 C.B. 305.

60 760 F.2d at 1043. Apparently as to the latter point, the fact that Bolker entered into the contract to exchange the property on the day of the liquidation did not weigh on the court.

61 65 T.C. 6 (1975).

62 81 T.C. 767 (1983), *aff'd*, 753 F.2d 1490 (9th Cir. 1985).

63 760 F.2d at 1044.

64 *Id.*

65 *Id.* at 1045.

66 *Id.*

67 *See id.*

68 *Id.*

69 450 F.2d 472 (5th Cir. 1971), *cert. denied.*, 408 U.S. 923 (1972).

70 *See id.* at 475.

71 324 U.S. 331 (1945).

72 *See* 450 F.2d at 475-760.

73 *See id.* at 477.

74 To qualify as an installment sale under Section 453(b)(1) at least one payment on the note must be made after the taxable year in which the sale occurs.

75 *See* Temp. Treas. Reg. § 15A. 453-1(b)(3)(i) (as amended 1994). For example, this regulation allows use of a standby letter of credit.

76 *See* Treas. Reg. § 1.453-9(c)(2) (as amended 1995). Note, however, Section 736 or Section 751 may cause a portion of the distribution to be taxable.

77 Treas. Reg. § 301.7701-3 (as amended 1999).

78 Priv. Ltr. Rul. 199911033 (Mar. 19, 1999).

79 This was not the actual name but the one used in the Memorandum.

80 *See* Rev. Rul. 66-191, 1966-2 C.B. 300; *McManus v. Commissioner,* 583 F.2d 443 (9th Cir. 1978), *aff'g* 65 T.C. 197 (1975).

81 *See* Treas. Reg. § 1.1031(k) (as amended 1994).

82 *See id.* at § 1.1031(k)-1(g)(4)(ii).

83 *See id.* at § 1.1031(k)-1(g)(6)(i).