MULTI-YEAR DEFERRED LIKE-KIND EXCHANGES BY PARTNERSHIPS—IS THE NEW REV. RUL. A TROJAN HORSE?

BY RICHARD M. LIPTON

The Service has chosen to use the format of a Revenue Ruling to analyze how a multi-year Section 1031 exchange affects a partnership that relinquishes encumbered property in year 1 and acquires encumbered replacement property in year 2. The importation of the Section 1031 rules into Subchapter K appears to have no precedent, and may produce unpleasant results where the replacement liabilities are less than the debt on the relinquished property.

One of the unique features of like-kind exchanges is that a deferred exchange can straddle two tax years, because a taxpayer is given 180 days to acquire replacement properties. This potential deferral has given rise to several questions, including the treatment of liabilities by a partnership that engages in a deferred like-kind exchange that crosses tax years.

The IRS recently provided guidance for such partnerships in Rev. Rul. 2003-56, 2003-23 IRB 985. The results generally are favorable, although the reasoning underlying the Ruling appears somewhat opaque. The results can be downright disadvantageous, however, for partners in a partnership that does not incur liabilities on the replacement property equal to the liabilities associated with the relinquished property. Indeed, the Ruling may best be characterized as a gift horse that looks more and more questionable on close examination.

BACKGROUND

Section 1031(a)(1) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for property of like-kind that is to be held either for productive use in a trade or business or for investment. In *Starker,* 602 F.2d 1341, 44 AFTR2d 79-5525 (CA-9, 1979), the court approved a nonsimultaneous Section 1031 exchange in which the taxpayer chose the replacement property at a later date.

In reaction to the *Starker* decision, Congress enacted Section 1031(a)(3), which provides that any property received by a taxpayer will be treated as not of like-kind if (1) the property is not identified as property to be received in the exchange by the day which is 45 days after the sale of the relinquished property, or (2) the property is received after the earlier of (a) the day that is 180 days after the date on which the taxpayer transferred the relinquished property, or (b) the due date (including extensions) for the taxpayer's federal income tax return for the tax year in which the transfer of the relinquished property occurred.

Implicit in Section 1031(a)(3) is recognition that in a like-kind exchange the transfer of the relinquished property can occur in one tax year (year 1) and the acquisition of the replacement property can occur in a different tax year (year 2), provided that the replacement property is acquired before the due date for the taxpayer's year 1 return. In general, if a taxpayer enters into a deferred exchange in good faith in the second half of a tax year and timely identifies replacement property but fails to close on the acquisition of the replacement property before the end of year 1, any gain realized by the taxpayer from the sale of the relinquished property is not recognized until the tax year in which the 180-day period ends (i.e., year 2).

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The Code also comtemplates that taxpayers frequently will receive boot in an exchange, i.e., property that is not of like-kind and the receipt of which does not qualify for nonrecognition of gain or loss. Section 1031(b) provides that if boot is received in an exchange, the taxpayer will recognize gain to the extent of the boot received. Under Reg. 1.1031(b)-1, consideration in the form of an assumption of liabilities (or a transfer of property subject to a liability) is treated as boot for purposes of Section 1031(b).

If in an exchange described in Section 1031(b), each party either assumes a liability of the other party or acquires property subject to a liability, then, in determining the boot received by each party, consideration given in the form of an assumption of a liability (or the receipt of property subject to a liability) is offset against consideration received in the form of an assumption of a liability (or the transfer of property subject to a liability). This "offset" rule is illustrated by Reg. 1.1031(k)-1(j)(3), Example 5:

EXAMPLE: B has an adjusted basis in Whiteacre of $40,000, which is encumbered by a mortgage of $30,000 and has an FMV of $100,000; B's net equity is $70,000. On 5/17/91, B transfers Whiteacre to C, who assumes the mortgage. On 7/5/91, C transfers Blackacre, which is encumbered by a $20,000 mortgage, has an FMV of $90,000, and net equity of $70,000, to B to complete the exchange. B assumes the mortgage on Blackacre. The consideration received by B in the form of the assumption by C of the liability encumbering Whiteacre (i.e., $30,000) is offset by the consideration given by B in the form of the assumption by B of the liability encumbering Blackacre (i.e., $20,000). Only the net difference, $10,000, is boot received by B in the exchange.

Partnership rules. The liability offset rules for an exchange become even more complicated when the taxpayer is a partnership. Section 752(a) provides that 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 the partner of partnership liabilities, is treated as a contribution of money by the partner to the partnership. Under Section 752(b), 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 reason of the assumption by the partnership of individual liabilities, is treated as a distribution of money to the partner by the partnership.

The 1031 liability netting rules, used to calculate boot, are simply transported into Subchapter K to determine if a partnership has made a deemed distribution.

Under Section 731(b), a distribution of money by a partnership to a partner results in gain to the extent that the money distributed exceeds the partner's basis in the partnership. Section 752(d) provides that in the event of a sale or exchange of an interest in a partnership, liabilities are to be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships.

The rules concerning the tax impact of a decrease in a partner's share of a partnership liability generally are applied at the end of a tax year. In Rev. Rul. 94-4, 1994-1 CB 196, the IRS considered the impact of deemed distributions under Section 752(b) with respect to a calendar-year taxpayer that owned an interest in a partnership. The Service concluded that during the calendar year, a decrease in a partner's share of partnership liabilities is to be treated as an advance or drawing of money that, under Reg. 1.731-1(a)(1)(ii), is not taxable at the time of the deemed distribution. Instead, the tax impact of the advance or draw is taken into account at the end of the partnership's tax year.

Another partnership calculation that focuses on the end of the tax year concerns the calculation of minimum gain. Under Reg. 1.704-2(d)(1), the amount of partnership minimum gain is determined by first computing for each partnership liability any gain the partnership would realize if it disposed of the property subject to that liability for no consideration other than full satisfaction of the liability, and then aggregating the gain that has been separately computed for each liability of the partnership.

For any partnership tax year, the net increase or decrease in partnership minimum gain is determined by comparing the partnership minimum gain on the last day of the immediately preceding tax year with the partnership minimum gain on the last day of the current tax year. Thus, mid-year changes in the amount of minimum gain generally are ignored in determining whether there has been an increase or decrease in partnership minimum gain. For example, a calendar-year partnership can increase the amount of its nonrecourse liabilities on December 31 of a tax year for the purpose of preventing a minimum gain chargeback.

Annual accounting. The final consideration in determining the tax consequences of a multi-year like-kind exchange is the impact of the annual accounting rules. Although taxpayers generally are required to take income into account using an annual accounting method, sometimes it is inappropriate to recognize income with respect to a transaction because the transaction remains "open." Indeed, the concept underlying the accrual method of accounting is that recognition is required when all the events have occurred that fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.[1] There is no specific guidance concerning the application of Section 451 to like-kind exchanges, although the underlying concepts in Section 1031 appear to be consistent with the deferral of income until all of the events have occurred to determine the tax consequences of the transaction. This approach is consistent with

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[1] Reg. 1.451-1(a).

the installment sale rules under Section 453, under which gain is deferred until payments are received.

THE NEW RULING

Rev. Rul. 2003-56 focuses on the impact of a year-end reduction of a partnership's liabilities as a result of a like-kind exchange where the relinquished property is disposed of in year 1 and replacement property, if any, is not acquired until year 2. The issues that arise are obvious:

- Do the partners have a deemed distribution under Section 752(b) because year-end liabilities are decreased?
- Is there a minimum gain chargeback?
- When are changes in the amount of the partnership's liabilities taken into account if liabilities increase or decrease as a result of the exchange?

The Ruling illustrates these issues through two examples.

- In the first example, P is a calendar-year general partnership with two equal partners. P owns property 1, which has an FMV of $300, an adjusted basis of $80, and is subject to a liability of $100. P enters into a deferred like-kind exchange pursuant to which the partnership transfers property 1 to a purchaser on October 16 of year 1. On January 17 of year 2, P receives property 2, which has an FMV of $260 and is subject to a liability of $60.
- The second example in the Ruling is the same as the first one, except that property 2 has an FMV of $340 and is subject to a liability of $140.

Thus, the first example illustrates the issues that arise when P's liabilities decrease, and the second illustrates the issues when P's liabilities increase.

Deemed Distribution

The IRS based its analysis in Rev. Rul. 2003-56 on the "liability netting" concept that underlies Section 1031. As noted above, in any Section 1031 exchange, for purposes of determining if the taxpayer received any taxable boot in the exchange, consideration given in the form of the receipt of replacement property subject to a liability (the replacement liability) is offset against consideration received in the form of the transfer of the relinquished property subject to a liability (the relinquished liability).[2] The Ruling states, on the basis of this "liability netting" rule, that if an exchange straddles two tax years of the partnership, the amount of the relinquished liability that exceeds the amount of the replacement liability is treated as money or other property received in the first of the partnership's two affected tax years, since the excess is attributable to the transfer of the relinquished property subject to the relinquished liability in that year. In addition, any gain resulting from receipt of boot in that first of the two affected tax years of the partnership must be recognized and reported in that year.

The Ruling takes the change in the partnership's liabilities into account in year 1 only when it would be detrimental to the taxpayer to do so.

Furthermore, the liability netting rule in Section 1031 is taken into account for purposes of determining any decrease in a partner's share of partnership liabilities under Section 752(b). Accordingly, if a partnership enters into a Section 1031 exchange that straddles two tax years of the partnership, each partner's share of the relinquished liability is offset with each partner's share of the replacement liability for purposes of determining any decrease in a partner's share of partnership liabilities under Section 752. Any net decrease is taken into account in the first of the two affected tax years of the partnership since it is attributable to the transfer of the relinquished property subject to the relinquished liability in that year.

In addition, pursuant to Rev. Rul. 94-4, any deemed distribution of money to the partners under Section 752(b) in the first of the two affected tax years of the partnership is treated as an advance or drawing of money to the extent of each partner's distributive share of partnership income for that year. For this purpose, any gain recognized by the partnership under Section 1031(b) from the net decrease in liabilities resulting from the exchange is included in the partners' distributive share of partnership income for the first of the two affected tax years of the partnership. An amount treated as an advance or drawing of money is taken into account by the partners at the end of that year.

The leap of logic (and statutory construction) that is encompassed in the foregoing conclusions in Rev. Rul. 2003-56 is stunning. The liability netting rules under Section 1031, which are used to determine the amount of boot that is received by a taxpayer in a like-kind exchange, are simply transported into Subchapter K for purposes of determining whether a partnership has made a deemed distribution. But the determination of boot for purposes of Section 1031 does not have anything to do with whether a partnership has made a distribution to its partners; the boot calculation merely affects the gain recognized in an exchange. Nothing in Section 1031 or Subchapter K, or the Regulations thereunder, authorizes the use of the liability netting rules in Section 1031 for purposes of determining whether a partner has received a distribution for purposes of Subchapter K.

What may be even more surprising is that the IRS did not use either an "open transaction" approach (including Section 453) or an analogy to Section 752(d) to support its analysis. Most practitioners had assumed that a multi-year like-kind exchange did not result in a decrease in liabilities for purposes of Section 752(b) on the grounds that the transaction is open until the amount of liabilities on the replacement property is known. Under this reasoning, any decrease (or increase) in liabilities would not need to be taken into account until the transaction was completed, because the dis-

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[2] Reg. 1.1031(b)-1(c).

position of the relinquished property would not constitute a completed transaction. Thus, a multi-year deferred like-kind exchange was treated like an installment sale in which cash was not received until year 2 (i.e., the year in which the amount of the liabilities encumbering the replacement property is known).

Although the open-transaction approach ignored the year-end calculation of liabilities under Sections 752 and 731, it most directly comported with the reality of a multi-year like-kind exchange as well as the generally applicable rules for recognition of income under Sections 451 and 453. It also deferred the gain recognition (as a result of the partnership's failure to incur sufficient debt) to the tax year in which gain was recognized on the like-kind exchange, so that no gain was recognized on the deemed distribution because the partnership had already recognized gain from the boot received in the exchange.[3]

Alternatively, some practitioners found solace in Section 752(d). Under this provision, in the event of a sale of a partnership interest, liabilities are treated in the same manner as liabilities in connection with a sale or exchange of assets. Arguably, if a taxpayer engaged in a like-kind exchange of a partnership interest, this provision would authorize the use of liability netting to ignore the application of Section 752(b). Because sales of partnership interests are excluded from like-kind treatment under Section 1031(a)(2)(D), Section 752(d) is not directly applicable to a like-kind exchange. Nevertheless, some practitioners drew an analogy to this provision (applying it to a sale of assets by a partnership instead of a sale of partnership interest) and viewed the provision as providing legal authority for "overriding" or "ignoring" the deemed distribution that would otherwise occur under Section 752(b) where a transaction involved a sale of partnership assets (instead of a sale of a partnership interest).

Net Increase in Liability

The use of the liability netting rules was not limited to finding a deemed distribution in the year of the sale of the relinquished property. The IRS further stated in Rev. Rul. 2003-56 that if a partner's share of the replacement liability exceeds the partner's share of the relinquished liability, only the net increase in liability is taken into account for purposes of determining the increase in the partner's share of partnership liability under Section 752(a). The net increase is taken into account in the second of the two affected tax years of the partnership since it is attributable to the receipt of the replacement property subject to the replacement liability in that year.

IRS solved the potential problem arising from 752(b) simply by ignoring it and superimposing the liability netting rules of 1031 on a partnership transaction.

Again, this result is a rather amazing extension of Section 1031 into Subchapter K. True, the liabilities of the partnership increased as a result of the acquisition of the replacement property. Also true, that increase did not occur until the second of the two affected tax years, when the replacement property (subject to the replacement liability) was acquired. But if the decrease in liability is deemed to occur in the first of the affected tax years for purposes of Subchapter K, which is when the relinquished property was sold, it would seem logical that any increase in the liability would be deemed to have occurred at the same time for purposes of Subchapter K. Rev. Rul. 2003-56, however, takes the change in the amount of the partnership's liabilities into account in the first year (the year of the sale of the relinquished property) only when it would be detrimental to the taxpayer to do so.

The Impact on Minimum Gain

The logical leaps do not stop with liability netting, however, because of the need to deal with issues concerning minimum gain. The Ruling provides that for purposes of determining partnership minimum gain, the partnership is deemed to own the replacement property as of the last day of the first of the two affected tax years (but only to the extent of the relinquished nonrecourse liability). If the amount of nonrecourse liabilities decreases, this will result in a minimum gain chargeback in that first year.

This result is consistent with the result if the relinquished liability is greater than the replacement liability, i.e., a distribution is deemed to occur at the conclusion of that first year. If, however, the amount of the replacement liability is greater than the relinquished liability, this same logic applies, but the Ruling prohibits an increase in minimum gain by "capping" the amount of the replacement liability at the amount of the relinquished liability.

Once again, there is no support for this limitation in either the Code or the Regulations. And the IRS did not use the open transaction approach that many practitioners had relied on to avoid a minimum gain chargeback until all aspects of the exchange were known by the partnership.

The Ruling's Examples

Rev. Rul. 2003-56 concludes by applying the Service's analysis to the two factual circumstances noted above.

EXAMPLE 1: P's amount realized is $300, which is the FMV of the replacement property, $260, increased by the $100 relinquished liability and decreased by the replacement liability of $60. P's adjusted basis in the relinquished property is $80, resulting in a realized gain of $220. The relinquished liability is offset by the replacement liability, but because the replacement liability was $40 less than the relinquished liability, P is treated as receiving $40 of boot in the exchange. Therefore, P recognizes gain on the exchange equal to the lesser of the gain realized, $220, or the boot received, $40.

The recognized gain is allocated

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[3] The boot would be equal to the net amount by which the liabilities encumbering the relinquished property exceeded the liabilities on the replacement property.

equally to P's partners in the year of the exchange, and under Section 752(b) each partner is treated as having received a deemed distribution from the partnership of $20. The deemed distribution is treated as an advance or draw that must be taken into account by each partner at the end of year 1. Because the $20 gain recognized by each partner on the exchange will equal the deemed distribution, there will be no further tax consequences under Subchapter K in year 1 (and no tax consequences at all in year 2 when the replacement property is actually acquired).

EXAMPLE 2: P's amount realized is $300, which is the FMV of the replacement property, $340, increased by the $100 relinquished liability and decreased by the replacement liability of $140. P's adjusted basis in the relinquished property is $80, again resulting in a realized gain of $220. But because the replacement liability of $140 exceeds the relinquished liability of $100, P is not deemed to receive any boot under the liability netting rule. Therefore, P does not recognize any gain in year 1, so that no gain is recognized by the partners.

In addition, the Ruling concludes that the decrease in P's liabilities is ignored at the end of year 1 (because the liabilities were netted for purposes of Section 1031), but the partners in P are deemed to have made an additional contribution to P of $20 each in year 2, which is when the replacement property (subject to the replacement liability) is acquired by P. Thus, the partners in P cannot take any advantage of the basis increase resulting from the replacement liability until the replacement property is acquired.

The practical effect of these two examples is that, where a like-kind exchange entered into by a partnership straddles two tax years, (1) any decrease in net liabilities in a Section 1031 exchange is taken into account by the partnership in the year of the exchange, and (2) any increase in net liabilities of the partnership is taken into account in the year in which the replacement property is acquired. Therefore, if gain is to be recognized, the taxpayer cannot postpone the gain recognition beyond the year of disposition of the relinquished property, but no benefit can be taken from the basis increase resulting from the acquisition of the replacement property until such property is actually acquired by the partnership. The fact that the partnership had *no* liabilities at all at the end of the tax year, when the impact of increases or decreases in liabilities is taken into account under Section 752, is simply ignored.

ANALYSIS

"Don't look a gift horse in the mouth!" That is the refrain often heard when Rev. Rul. 2003-56 is discussed. This aphorism is appropriate because the Ruling has questionable logic but reaches a favorable conclusion for partnerships that incur liabilities on the acquisition of a replacement property that equal or exceed the liabilities on the relinquished property. These partnerships view Rev. Rul. 2003-56 as favorable because it eliminates the possibility of adverse results due to the fact that, from a purely technical perspective, the partnership had suffered a decrease in its liabilities at the end of year 1. Nevertheless, even a gift horse deserves to be examined closely from time to time.

The favorable aspect of Rev. Rul. 2003-56 is that the potential literal application of Section 752(b) is avoided by a partnership that engages in a multi-year like-kind exchange. If Section 752(b) had been applied literally, the partners could be required to recognize gain as of the end of year 1 because of the decrease in liabilities, i.e., the liabilities on the relinquished property no longer exist as of the end of that tax year. Section 752(b) would require a deemed distribution, which could then be taxable under Section 731(a). This literal result would occur under Subchapter K, notwithstanding that the partnership acquired replacement property the following year in a nonrecognition transaction under Section 1031.

Rev. Rul. 2003-56 solves this potential problem arising from the application of the rules of Subchapter K simply by ignoring them and superimposing the liability netting rules of Section 1031 on a partnership transaction. The liability incurred by the partnership in the following year as part of the acquisition of the replacement property is "netted" against the liability on the relinquished property, so that the partners have to take into account a deemed distribution only to the extent that there has been an overall decrease in the partnership's liabilities when the entire transaction ends.

As long as the partnership incurs a sufficient liability in acquiring the replacement property, everything is copasetic.

As long as the partnership incurs a sufficient liability in acquiring the replacement property, everything is copasetic—there is no deemed distribution, so the partners do not have to recognize any gain under Subchapter K. But if the exchange results in a decrease in liabilities (i.e., the liability on the replacement property is less than the liability on the relinquished property), then the deemed distribution is taken into account in the year of the sale of the relinquished property.

This approach is further extended in Rev. Rul. 2003-56 to cover whether there has been a reduction in minimum gain as a result of the sale of the relinquished property. Because the liability on the relinquished property has disappeared, there clearly would be a reduction in minimum gain (resulting in a minimum gain chargeback) if the liability on the replacement property is not taken into account until the following year. The Ruling solves this problem by using the replacement property (and its tax basis) for purposes of determining whether there is a reduction in minimum gain as of the end of year 1, notwithstanding that the partnership did not yet own the replacement property at that time. If the exchange results in a decrease in liabilities, the minimum gain chargeback rules would likewise apply by taking into ac-

Practice Notes

Nothing in Rev. Rul. 2003-56 says anything about an "effective date." Although it is possible that IRS will apply the reasoning in the Ruling only to transactions that occur after 5/9/03, the date of its advance publication, a Revenue Ruling usually is a statement of the law and not administrative procedure. Accordingly, it is likely that the Service will maintain that its analysis of the situations described in the Ruling will apply to any Section 1031 exchange involving a partnership in any open tax year.

What should taxpayers do? For transactions still in the contemplation stage, it may be possible for the taxpayer to manipulate the timing so that both legs of the exchange occur in the same tax year. If not, tax advisors will have to take the Service's reasoning into account in determining the Subchapter K consequences for the partnership and its partners.

Partnerships and partners that do not like the results engendered by Rev. Rul. 2003-56 will face an unpleasant choice of living with those results, or taking—and adequately disclosing—a contrary position on their returns; if so, they had better be prepared to challenge Rev. Rul. 2003-56 in court.

count the liability and basis of the replacement property, so that the minimum gain rules would have to be applied as well as the other rules in Subchapter K.

This is a favorable result for the partners in a partnership that engages in a multi-year exchange in which the liability on the replacement property exceeds the liability on the relinquished property. Nevertheless, any relationship between this result and Subchapter K appears to be coincidental. Instead, the Ruling reaches what may be viewed as the "fair" result for partnerships that incur sufficient debt in the following tax year, even if the applicable law and Regulations may not quite get there.

The Service was not willing to take this analysis to its logical conclusion, however, if that conclusion would result in an additional benefit to the taxpayer. The increase in liabilities resulting from the acquisition of the replacement property, if taken into account at the end of the year in which the sale of the relinquished property occurred, could result in a tax benefit to the partners by increasing their basis in the partnership. The partners could use this basis increase to take advantage of losses suspended under Section 706(d) or to prevent a deemed distribution relating to the reduction in other liabilities of the partnership. So Rev. Rul. 2003-56 provides that any *increase* in liabilities is not taken into account until the following year, even though any *decrease* in liabilities is taken into account in the year of sale. In other words, the Service was willing to give taxpayers a favorable interpretation of the rules to prevent an adverse result, but not to give them a tax benefit.

What is most interesting about this problem is that it is not a new one—multi-year exchanges have been sanctioned by Section 1031(a)(3) for almost two decades, and such exchanges have been around even longer. Many practitioners had gotten comfortable with the idea (reached through an analogy to Section 453) that multi-year like-kind exchanges should be viewed as open transactions, so that the tax consequences to the partners in a partnership should not be determined until the replacement property was acquired. This approach would result, however, in a deferral of gain recognition in situations in which the liability on the replacement property was less than the liability on the relinquished property, which apparently is not the conclusion the IRS wanted to reach. Likewise, some practitioners had concluded that, by analogy, under Section 752(d) a multi-year exchange did not result in adverse tax consequences to the partners if the liability on the replacement property equaled or exceeded the liability on the relinquished property.

Why did the IRS take neither of these approaches in Rev. Rul. 2003-56? Perhaps the Service was concerned that taxpayers would use the open transaction approach to defer gain recognition when the taxpayers did not intend to acquire replacement property, or expected to acquire replacement property but to recognize some gain in the transaction. Furthermore, the open transaction approach did not comport with the Service's conclusion that the partners in a partnership would receive a deemed distribution in the year of the sale of the relinquished property if liabilities were decreased in the subsequent year. Apparently concerned that its desired result could not be justified under an open transaction approach, the IRS instead used a liability-netting analysis that was consistent with its desired answer. But the Service could not even take this approach to its logical conclusion because of the benefits that could be obtained by partnerships that increased the total amount of their liabilities.

The other possible way for the IRS to analyze these transactions would have been to create an analogy to Section 752(d), but the Service's failure to do so indicates that the IRS was likely concerned that an expansion of Section 752(d) to like-kind exchanges would open up tax planning opportunities for taxpayers in circumstances other than like-kind exchanges. Perhaps the IRS was concerned that Section 752(d) could be used to create tax shelters of one type or another. Or perhaps the IRS simply wanted to provide relief for these like-kind exchanges without addressing any other situations.

How might the Service have provided relief to like-kind exchanges without undermining the basic principles of Subchapter K? The IRS probably should have adopted the approach taken by most practitioners, which was to view the transaction as open, thereby deferring any gain recognition until the exchange was completed. This approach would have avoided a deemed distribution as a result of the debt decrease, but it also would have meant

that there would be no gain recognition in the year of the exchange if the partnership did not incur sufficient liabilities in the following year.[4] Such an open transaction approach also would have been most consistent with economic reality, in that the partnership usually would not know at the end of the first of the two affected tax years the amount of the liabilities that would be incurred in the following year with respect to the acquisition of replacement property.

Alternatively, if the IRS wanted to allow deferral to partnerships that incurred sufficient liabilities but did not want to endorse an open transaction approach, under several recent precedents the IRS could have issued a Revenue Procedure indicating that the Service would not attempt to impose tax consequences on any partner if replacement property were timely acquired with sufficient liabilities. A Revenue Procedure sets forth the approach that the IRS will take from an administrative standpoint in enforcing the tax laws, even if the applicable law is not completely clear. For example, in Rev. Proc. 2000-37, 2000-2 CB 308, the IRS provided a safe harbor for reverse exchanges, even if such transactions were not expressly authorized in the Code or Regulations. Likewise, in Rev. Proc. 93-27, 1993-2 CB 343, the IRS announced that it would not challenge the nontaxability of the issuance of a profits interest, even though there were conflicting authorities on the issue.[5]

In the partnership-Section 1031 situation, the Service could have issued a Revenue Procedure stating that it would not attempt to assert under Section 752(b) that there was a deemed distribution by a partnership (or a decrease in minimum gain) if (1) a partnership entered into a multi-year like-kind exchange and (2) the partnership's liabilities did not decrease after the exchange was completed. Such a Procedure would not have had to discuss the applicable authority for this position or any of the corollary issues. The IRS thereby could have provided comfort to partnerships that were entering into legitimate multi-year exchanges without a detailed legal analysis. And the Service would not have waived its right to assert an additional tax liability against the partners in a partnership that did not incur sufficient liabilities in the following tax year when the exchange was completed. By issuing a Revenue Ruling, however, the IRS published a questionable legal analysis. Such analysis is more appreciated where the result is generally favorable to taxpayers, but it sets a precedent for the IRS to disregard the applicable law, which is something that most taxpayers may come to rue in the future.

CONCLUSION

Partnerships contemplating Section 1031 exchanges that will straddle two tax years now will have to contend with the Service's published position in Rev. Rul. 2003-56. No longer can practitioners assume that open transaction treatment will apply to the Subchapter K consequences, and the partners will have to determine if there will be a deemed distribution or a minimum gain chargeback. ■

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[4] Any basis increase, however, would be deferred until the year in which the replacement property was acquired.

[5] Compare Diamond, 56 TC 530 (1971), *aff'd* 492 F.2d 286, 33 AFTR2d 74-852 (CA-7, 1974), and Campbell, TCM 1990-236, *rev'd* 943 F.2d 815, 68 AFTR2d 91-5425 (CA-8, 1991). See also Rev. Proc. 2001-43, 2001-2 CB 191, and Mincey, Sloan, and Banoff, "Rev. Proc. 2001-43, Section 83(b), and Unvested Profits Interests—the Final Facet of *Diamond*?" 95 JTAX 205 (October 2001), and earlier articles cited therein.

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