

Acquisitions, Dispositions & Structuring Techniques Corner

By *Richard M. Lipton*

Oregon Tax Court Magistrate Rejects Attack on a “Swap and Drop” Transaction

Sometimes interesting tax cases arise in unusual venues. In *Marks v. Department of Revenue*, the Magistrate Division of the Oregon Tax Court addressed the Oregon Department of Revenue (“ODR”) contention that Code Sec. 1031 of the Internal Revenue Code (which has been adopted in relevant part by the Oregon legislature) did not apply to a like-kind exchange in which the taxpayer immediately transferred the replacement property to a partnership in exchange for a partnership interest. The court squarely confronted—and rejected—each of the arguments raised by the ODR.¹

The facts in the case, which was decided on cross motions for judgment, were very briefly stated. According to the court, the taxpayer transferred relinquished property for replacement property, and then the replacement property was contributed to a partnership. (The decision does not clearly state whether the partnership was a general partnership or a limited partnership.)

The ODR raised a series of arguments as to why Code Sec. 1031 should not apply to this transaction. First, the ODR claimed that under the step-transaction doctrine, the taxpayers should be deemed to have exchanged the relinquished property for a partnership interest, because the taxpayers always intended to, and in fact did, contribute the replacement property to a partnership immediately upon receipt. The ODR recognized that prior to 1984, the U.S. Tax Court and the Ninth Circuit had concluded that Code Sec. 1031 applied to a similar transaction in *N.J. Magneson*.² However, the ODR contended that the enactment of Code Sec. 1031(a)(2)(D) in 1984, which provides that Code Sec. 1031(a)(1) does



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not apply to any exchange of interests in a partnership, would have resulted in a different decision for post-1984 exchanges.

The court rejected that argument by pointing to the U.S. Tax Court's decision in *B.B. Maloney*,³ in which the U.S. Tax Court had concluded that the purpose of Code Sec. 1031 was to defer recognition of gain or loss on a transaction in which, although in theory the taxpayer has realized a gain or loss, the taxpayer's economic situation in substance is the same before and after the transaction. The Oregon court specifically quoted (approvingly) the U.S. Tax Court's statement that the mere addition of another nontaxable transaction (described in Code Sec. 721) does not automatically destroy the nontaxable status of the transaction under Code Sec. 1031.

The Oregon court emphasized that in the transaction before it, the exchanged property was owned by individuals, who subsequently transferred the property to a new partnership. The Oregon court also noted that *Maloney* was decided after both *Magneson* and the adoption of Code Sec. 1031(a)(2)(D), although the Oregon court did not address that the tax year at issue in *Maloney* was prior to 1984. Put simply, the Oregon court accepted the taxpayer's argument that a contribution of property to a partnership is not incompatible with a Code Sec. 1031 like-kind exchange.

The ODR further contended that *Magneson* and prior decisions should be distinguished on the grounds that the partnership at issue in *Magneson* was not formed under the laws of Oregon. Under Oregon law, taxpayers that contribute property to a partnership no longer own or have unrestricted control of the property; the property is owned by, and must be managed on behalf of, the partnership. Thus, the ODR argued that the taxpayers do not hold the replacement property for investment if they contribute it to an Oregon partnership.

The Oregon magistrate rejected this argument on the grounds that the *Magneson* court was fully aware that there are significant differences between a tenancy-in-common interest on the one hand and a partnership interest on the other, including particularly the ability of the owner to alienate the

property. The Ninth Circuit had emphasized that these differences are not dispositive; what matters is the continuity of investment in like-kind property. Thus, if at the time of the exchange, the taxpayer intends to contribute the property to a partnership and the partnership will hold the property for investment, the holding requirement of Code Sec. 1031 is met, despite the limited alienability of the property by the partner. The taxpayer's underlying purpose to reinvest in like-kind property—even if such property is held through a partnership—satisfies the requirements of Code Sec. 1031.

The Oregon magistrate then looked at whether all of the specific requirements of Code Sec. 1031(a) were met in this situation. After concluding that such requirements were met, the court further stated that the exchange of property for a partnership interest, is not prohibited by Code Sec. 1031(a)(2)(D) because the taxpayers had exchanged property for like-kind property and then contributed the exchanged property for a partnership interest which is not incompatible with nonrecognition under

Code Sec. 1031, citing *Maloney*.⁴ Therefore, the Oregon magistrate upheld the "swap and drop" transaction entered into by the taxpayer.

Marks is a welcome determination. The Oregon court followed the other courts that have considered this issue. In light of its failure to convince any court that a "swap and drop" transaction is taxable, the IRS should have long ago renounced this position. The IRS's failure to withdraw Rev. Ruls. 75-292 and 77-337,⁵ remains a mystery, but it is fair to say that most practitioners simply ignore them (or, at least, advise clients to go ahead with transactions but alert the clients to the risk) because they are clearly wrong. Fortunately, the Oregon magistrate reached the same conclusion.

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ENDNOTES

¹ *Marks v. Department of Revenue*, Ore. Tax Ct., No. TC-MD 050715D, 2007 Ore. Tax LEXIS 111, July 24, 2007.

² *N.J. Magneson*, CA-9, 85-1 ustr ¶19205, 753 F2d 1490.

³ *B.B. Maloney*, 93 TC 89, Dec. 45,863 (1989).

⁴ *Id.*, 93 TC at 102.

⁵ Rev. Rul. 75-292, 1975-2 CB 333 and Rev. Rul. 77-337, 1977-2 CB 305.