THE 'STATE OF THE ART' IN LIKE-KIND EXCHANGES

BY RICHARD M. LIPTON

A lack of IRS guidance on everyday issues regarding Section 1031 transactions has created an environment where sophisticated practitioners have devised apparently workable rules. For the well-advised taxpayer, like-kind exchange treatment should be attainable in most situations.

Section 1031(a), which provides for the nonrecognition of gain in like-kind exchanges, is one of the provisions of the Code most commonly used by taxpayers to defer taxation. Although like-kind exchanges occur regularly, important questions remain involving the application of this provision. Tax practitioners have developed common-sense answers to many of these questions.

Some of the most often raised practical questions concerning the application of Section 1031 are:

- The treatment of "reverse exchanges."
- The tax effect if a taxpayer encumbers replacement property immediately after an exchange.
- The tax consequences if the relinquished property is leveraged immediately before the exchange.
- Whether tenancy-in-common interests in real estate qualify for like-kind treatment.
- If the relinquished property is held by a partnership, how some of the partners can receive cash while other partners receive replacement property.
- Whether a partnership that engages in an exchange can distribute the replacement property to its partners.

STATUTORY AND REGULATORY BACKGROUND

Section 1031(a) 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 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.[1] Thus, there are four requirements for a tax-free exchange:

1. There must be an "exchange."
2. The exchange must be of "property" of a type that qualifies under Section 1031.[2]
3. The replacement property must be of like kind to the property relinquished.
4. Both the relinquished property and the replacement property must be held for productive use in a trade or business or for investment.

The general rule in Section 1031(a) requires that qualifying property must be exchanged *solely* for other qualifying property. Section 1031(b) provides, however, that if an exchange otherwise would be eligible for tax-free treatment under Section 1031(a) but for the receipt of cash or nonqualifying property (boot), then any gain realized on the exchange is recognized to the extent of the boot received.[3] Taxable boot includes relief from liabilities. The Regulations under Section 1031 expressly permit a taxpayer to determine whether liabilities have been relieved using a "netting" concept, under which the taxpayer's liabilities that are assumed or taken subject to by the other party to the exchange may be offset against liabilities encumbering the replacement property or taken subject to by the taxpayer. Liabilities of the taxpayer encumbering his relinquished property also may be offset by cash given by the taxpayer to the other party.[4]

Like-kind exchanges result in tax deferral, not tax elimination. To preserve the deferred gain, Section 1031(d) provides that the basis of the replacement property received in a Section 1031 exchange is equal to the basis of the property transferred, reduced by any cash received and any loss recognized and increased by any

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gain recognized. The basis of property received by a taxpayer in a like-kind exchange also may be increased by any cash paid by the taxpayer. The taxpayer's holding period for the replacement property will include the period during which the taxpayer held the relinquished property, i.e., the holding periods are tacked together.

Special rules apply if an exchange involves related parties. Under Section 1031(f), if a taxpayer obtains nonrecognition treatment on an exchange of property with a related person,[5] that treatment will be lost if the taxpayer or the related person disposes of either property within two years. The two-year period will be suspended under Section 1031(g) during any period in which any of the exchanged properties is subject to a put, a call, a short sale, or a transaction with similar effect.

It is fair to say that Congress probably believed initially that like-kind exchanges would apply only to simultaneous transfers between two persons. The law quickly evolved, however, to allow both multiparty exchanges as well as deferred exchanges. In a multiparty exchange, the taxpayer (X) holds relinquished property (P) that is sold to a buyer (B), and B acquires the property (R) desired by X from seller (S), who conveys R to X on behalf of B. Although the IRS initially argued that such three-party exchanges did not satisfy Section 1031, after losing in court[6] the IRS eventually capitulated.

A significant outgrowth of the rules permitting multiparty exchanges are the Regulations allowing deferred exchanges. These exchanges are often referred to as *Starker* transactions after the Ninth Circuit decision that first blessed such arrangements. In *Starker*, 602 F.2d 1341, 44 AFTR2d 79-5525 (CA-9, 1979), the taxpayer transferred property in exchange for a promise by the recipient to convey like-kind property chosen by the taxpayer at a later date.

In response, Congress enacted Section 1031(a)(3), which allows the transferor of the relinquished property up to 45 days to identify the replacement property and 180 days to close on the acquisition of the replacement property. The taxpayer may identify any three properties or multiple properties with an FMV not in excess of 200% of the FMV of the relinquished property.[7] Most taxpayers prefer to use the three-property rule because of the certainty it engenders.[8]

Much has been written about the Regulations that permit taxpayers to engage in deferred like-kind exchanges.[9] Basically, these Regulations set forth detailed (and generally taxpayer-friendly) guidance concerning how a taxpayer can comply with the deferred-exchange requirements in Section 1031(a)(3). Most important, the Regulations contain safe harbors that taxpayers can use to avoid constructive receipt of the proceeds from the relinquished property. These safe harbors have resulted in the creation of an entire industry—qualified intermediaries and title companies that stand ready, willing, and able to assist taxpayers in completing deferred exchanges that are nontaxable under Section 1031.

Although the Regulations and the courts have resolved many questions under Section 1031, several issues still remain.

REVERSE EXCHANGES

One of the most common problems encountered by a taxpayer who desires to engage in a Section 1031 exchange is the inability to identify and acquire replacement property within the 45-day and 180-day periods provided in Section 1031(a)(3). Even more frustrating, however, is when a taxpayer finds the replacement property *before* the taxpayer has sold the relinquished property. This frequently occurring situation has caused taxpayers to wonder whether they could engage in a "reverse exchange" in which the replacement property is acquired first.

There currently is no definitive authority concerning reverse exchanges, although the IRS has issued two private rulings that appear to permit such transactions.[10] The Section 1031 Regulations do not prohibit reverse exchanges, and IRS personnel have stated publicly that, as part of the Treasury Business Plan for 1999, the Service is currently considering the issuance of guidance that would permit reverse exchanges in limited situations.[11]

In the absence of guidance, what is a taxpayer to do? In most situations, a taxpayer will want to engage in a "parking" transaction in which the replacement property is acquired by a friendly person (FP), who will sell the replacement property to the taxpayer after the taxpayer is able to dispose of the relinquished property. If such a transaction is structured properly, the taxpayer would be able to avail herself of the safe harbor in the Section 1031

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1 See Levine, 567-2nd T.M. (BNA), *Taxfree Exchanges Under Section 1031*; Cuff, "Real Estate and the Deferred Exchange Regulations," ALI-ABA Course of Study: Creative Tax Planning for Real Estate Transactions (1997); Egerton and Sowell, "Like Kind Exchanges of Real Properties," 11 Tax Mgt. Real Est. J. 189 (1995).

2 Under Section 1031(a)(2), the properties involved in a like-kind exchange may not be stock in trade or other property held for sale, stocks, bonds or notes, other securities or evidences of indebtedness or interest, interests in a partnership, certificates of trust, or beneficial interests or choses in action.

3 If a loss is realized on a like-kind exchange in which boot is received, the loss is not recognized.

4 Reg. 1.1031(d)-2. In contrast, if the taxpayer receives cash or nonqualifying property to compensate for differences in net value as a result of liabilities, the cash or nonqualifying property is taxable boot.

5 For purposes of this rule, Sections 267(b) and 707(b) apply to determine if two persons are related.

6 Barker, 74 TC 555 (1980).

7 Reg. 1.1031(k)-1(c)(4).

8 This rule does open questions, however, as to what constitutes a "property" for purposes of Section 1031. See Shop Talk, "Identification of Replacement Property—What Is a 'Property'?," 88 JTAX 190 (March 1998), and "More on Identification of Replacement Property Under Section 1031," 89 JTAX 62 (July 1998).

9 Reg. 1.1031(k)-1. See Handler, "Final Regs. on Deferred Like-Kind Exchanges Provide Additional Clarification," 75 JTAX 10 (July 1991); Bengal and Dasaro, "Deferred Real Estate Exchanges Under Section 1031: New Regulations Create Guidelines for *Starker* Exchanges," 9 J. Tax'n Inv. 91 (Winter 1992); Fellows and Yuhas, "Deferred Like-Kind Exchanges: An Analysis of the Final Regulations," 16 Rev. Tax'n Indiv. 124 (Spring 1992).

10 Ltr. Ruls. 9814019 and 9823045.

11 Comments by Kelly Alton, Special Counsel to the IRS Assistant Chief Counsel (Income Tax and Accounting), at the May Meeting of the ABA Tax Section, to the Committee on Sales, Exchanges and Basis, 5/1/99, in Washington, D.C.

Regulations in buying the replacement property from the FP when she finally locates a buyer for the relinquished property.

Appropriate FPs. The most frequently asked question in parking transactions is who can serve as the FP. The only iron-clad rule in this regard is that the FP cannot be a related person within the meaning of Section 1031(f); this bars a family member or a controlled entity from serving. In addition, it generally is recommended that the FP not be a person who easily could be viewed as an agent of the taxpayer, such as the taxpayer's lawyer or accountant. Instead, the FP should be an unrelated person who has a profit motive in entering into the transaction.

Financing the FP. Another frequently asked question is whether the taxpayer can lend the purchase price for the replacement property to the FP. Although there is no guidance on this issue, it does not appear that such a loan will have an adverse effect on the subsequent exchange. A better way to structure such transactions, however, may be to have FP borrow money to acquire the replacement property, with the loan guaranteed by the taxpayer (who also waives any right of subrogation against the FP). If the amount that can be borrowed from an unrelated lender is insufficient to acquire the replacement property, the needed equity could be loaned from the taxpayer to the FP, but given the lack of authority the risks would have to be highlighted to a client.

The question becomes even more difficult if the loan is made on a nonrecourse basis, with the only collateral being the replacement property; needless to say, the FP (no matter how friendly it may be) usually will prefer this approach. Although this transaction probably works as well, a recourse (or limited recourse) loan is probably more advisable. Nonetheless, if the parties to a reverse exchange insist on a nonrecourse loan, their tax advisor probably should permit them to proceed on that basis but, again, the risks in the transaction would have to be highlighted to a client.

Bona fide ownership. It also is important that the FP not serve as the taxpayer's agent in holding the replacement property. Thus, the FP must have some risk of loss during the period that it (and not the taxpayer) holds the replacement property, and the FP cannot transfer substantially all of the benefits and burdens of ownership of the replacement property to the taxpayer.[12] As a practical matter, this means that the FP will receive any income (which will be used to pay debt service) and must be responsible for any losses (such as uninsured torts) that occur on the property during the FP's term of ownership. On the other hand, the FP and the taxpayer probably could enter into a contract under which the FP would be obligated to sell the replacement property to the taxpayer on a stated future date and at a fixed price, provided that the FP enjoys the benefits and burdens of ownership of the property until then.

Construction delays. In another common situation, a taxpayer who owns property that she desires to sell will want to acquire land with a to-be-built building on it; construction of the improvements may take longer than the 180 days permitted in Section 1031(a)(3). In such situations, it is common for the FP to acquire the land and construct the building using funds loaned to the FP by the taxpayer. Again, although there are no authorities that specifically approve such transactions, they do not appear to violate Section 1031. The taxpayer must make certain, however, that the FP is not acting as the taxpayer's agent, but this usually can be accomplished through careful drafting of the contract under which the FP agrees to acquire the land and construct a build-to-suit building thereon.

LEVERAGE AFTER AN EXCHANGE

A practical question frequently raised by taxpayers who engage in like-kind exchanges is whether they can encumber the replacement property after the exchange and, if so, when. This allows the taxpayer to withdraw equity from the property.

As a general rule, a taxpayer does not incur any tax liability when debt is incurred. Some tax practitioners have wondered whether this general rule applies if the debt is incurred in connection with the receipt of replacement property in a like-kind exchange. The concern is whether a like-kind exchange followed by the receipt of debt proceeds should be viewed as the functional equivalent of the receipt of boot by the taxpayer. Some practitioners also have suggested that, to avoid an appearance that a transaction is tax-motivated, a taxpayer should wait (preferably 30–60 days) before encumbering the replacement property. The following illustration puts this issue into a practical perspective.

Example: John owns Blackacre, which has an FMV of $1 million and a basis of $100,000. If John sold Blackacre, he would receive $1 million in cash and recognize $900,000 of gain, on which he would have to pay (at a 20% rate) $180,000 of federal income tax. If John simply traded Blackacre for Whiteacre, also worth $1 million, John would own a replacement property but he would have no cash. If, however, John could encumber Whiteacre with $1 million of debt immediately after the exchange, John would have disposed of Blackacre, placed $1 million in his pocket, and not have to pay any tax.

Your author believes that there is *no* reason why a taxpayer cannot encumber property after the exchange. There probably is not even any good reason why the taxpayer should have to wait before the replacement property is encumbered. Put simply, the receipt of debt proceeds does not give rise to taxable income, and the fact that the debt is incurred immediately after a like-kind exchange should not alter this result. Indeed, your author subscribes to the "one nanosecond rule," under which the taxpayer who acquires replacement property can then immediately incur debt secured by the replacement property.

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[12] For example, the taxpayer should not be entitled to receive the income from the replacement property during the time that it is owned by the FP, although such income could be used to service any loan from the taxpayer to the FP.

LEVERAGE BEFORE AN EXCHANGE

A more difficult question is whether a taxpayer can encumber a property immediately *before* a like-kind exchange. The limited authorities indicate that such a transaction is risky, although your author believes that the theoretical basis for adverse tax consequences is tenuous.

The IRS has indicated that it may take the position that encumbering a property immediately before an exchange could result in boot to the taxpayer. In Ltr. Rul. 8434015, the Service concluded that the effect of encumbering property before an exchange was to permit the taxpayer to cash out of the property without incurring the corresponding tax for money received under Section 1031. The IRS argued that the netting rules should not be literally applied to achieve this result. In reaching this conclusion, the Service argued that *Garcia*, 80 TC 491 (1982), which permitted liability netting, should not be applicable because that case involved an assumption of a debt with independent economic significance.

The logic underlying Ltr. Rul. 8434015 is questionable. As noted above, it is well established that a taxpayer can encumber property without tax consequences. Furthermore, if property is encumbered and then transferred as part of a like-kind exchange, the Regulations are clear that the transferor will recognize gain unless an equal or greater amount of debt encumbers the replacement property received in the exchange. Thus, from a before-and-after perspective the taxpayer's liabilities will not be reduced as a result of a like-kind exchange.[13]

Moreover, analytical support for the conclusion that no gain is recognized merely because property is encumbered before a like-kind exchange can be found in the Regulations under Section 707(a)(2)(B), relating to disguised sales between partners and partnerships. In general, Section 707(a)(2)(B) requires a taxpayer to recognize gain or loss if (1) property is transferred to a partnership, (2) the transferor receives a distribution of money or other property from the partnership, and (3) the effect of the transaction is a sale.

The Section 707(a)(2)(B) Regulations recognize that the economic equivalent of a sale could be obtained if a taxpayer encumbers property a short time before the property is transferred to the partnership. Accordingly, the Regulations provide that if property is transferred to a partnership subject to a nonqualified liability,[14] or if the nonqualified liability is assumed by the partnership, the transaction is treated as a cash distribution to the transferor to the extent that the transferor's share of the liability is reduced. For purposes of our discussion, the important aspect of this rule is that there are no tax consequences under Section 707(a)(2)(B) if and to the extent that the transferor's share of the liability is not reduced. Thus, if Harry encumbers Greenacre with $1 million of debt immediately before transferring Greenacre to a partnership, Harry will have *no* tax consequences as long as he is allocated at least $1 million of the partnership's debt after the transfer.

Logically, the same result should apply in Section 1031 exchanges. Thus, a taxpayer should be able to encumber the relinquished property immediately before a like-kind exchange *if* the replacement property received in the exchange is encumbered by an equal or greater liability. In that situation, although the taxpayer has "monetized" her property, she has done so by increasing her debt, which is not a taxable event.

TENANCY-IN-COMMON INTERESTS

The question of whether tenancy-in-common interests qualify for like-kind treatment under Section 1031 usually arises in two situations:

- The seller of the relinquished property cannot afford to purchase an entire property but has sufficient funds to purchase an undivided interest in the replacement property.
- A partnership that owns real property distributes tenancy-in-common interests to its partners because some of the partners want to sell their interests for cash while others want to engage in like-kind exchanges.

The first situation, which raises the theoretical question about tenancy-in-common interests, is addressed here; the partnership circumstance is discussed below.

The tenancy-in-common issue arises because partnership interests do not qualify for like-kind exchange treatment under Section 1031(a)(2)(D). The distinction between "partners" and "tenants in common" is a very fine one. For federal income tax purposes, a "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not a trust, an estate, or a corporation.[15] Nevertheless, a joint undertaking merely to share expenses is not a partnership. Reg. 301.7701-1(a)(2) provides, in relevant part:

"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 therefrom.... [M]ere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes."

Whether the parties have formed an entity is a question of fact, and while all circumstances must be considered, the essential question is whether the parties intended to, and did in fact, join together for the conduct of an undertaking or enterprise.[16] In *Luna*, 42 TC 1067 (1964), the Tax Court identified certain factors that bear on whether a venture is a partnership for tax purposes:

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[13] On the other hand, under Temp. Reg. 15A.453-1(b)(2)(iv), indebtedness placed on property in contemplation of a disposition is not qualifying indebtedness for purposes of the installment sale rules. The IRS could refer to this rule by analogy as support for its position that indebtedness placed on property prior to a like-kind exchange results in boot.

[14] Generally, with certain limited exceptions, a nonqualified liability is a liability not incurred to acquire property and which was incurred within two years of the date of transfer of property to the partnership. Reg. 1.707-5(a)(6).

[15] Sections 761(a), 7701(a)(2).

[16] Culbertson, 337 U.S. 733, 37 AFTR 1391 (1949).

- 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.
- Whether business was conducted in the joint names of the parties.
- Whether the parties filed federal partnership returns or otherwise represented to the IRS or to persons with whom they dealt that they were joint venturers.
- Whether separate books of account were maintained for the venture.
- Whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.

In Rev. Rul. 75-374, 1975-2 CB 261, two co-tenants each owned 50% interests in a large apartment complex with substantial recreational facilities. The co-owners employed an agent to manage the apartments on their behalf. The agent negotiated leases; collected rent; paid property taxes, insurance premiums, repair and maintenance expenses; and provided the tenants with customary services, such as heat, air conditioning, trash removal, unattended parking, and maintenance of public areas. The agent also provided certain additional services to the tenants, such as attendant parking, cabanas, and gas and electricity, for which the tenants paid the agent a separate charge and from which the agent separately profited. The Ruling concluded that no partnership had been created between the co-tenants.[17]

On the other hand, a partnership has been found where there has been a sharing of income or profits. *Bussing*, 88 TC 449 (1987), involved a syndicated co-ownership sale/leaseback of computer equipment subject to triple net leases. The court found a partnership existed because of the shared economic interest of the investors and the sublessor. A similar "sharing of interests" motivated the court to find that a partnership existed in *Bergford*, 12 F.3d 166, 73 AFTR2d 94-498 (CA-9, 1993).

The impact of these authorities is that it is possible to have co-ownership without creating a partnership, although it is not easy to accomplish. The key concern is whether there is a sharing of profits; if there is, a partnership almost certainly will be found. Another important factor is the level of activity involved in the ownership and operation of the property—the greater the level of activity, the greater the likelihood that a partnership exists. For this reason, it may be difficult to have mere co-ownership of an actively conducted trade or business.

For purposes of like-kind exchanges, the practical issue that arises involves the creation of passive ownership that does not result in the sharing of profits. This is frequently accomplished by having co-owners enter into a net lease of their property to a third party (the "lessee"), who in turn releases the property to the actual tenants. The co-owners receive only rental income from the lessee, which should not result in the creation of a partnership. The co-owners usually would not enter into any type of co-ownership or agency agreement involving the property; instead, their rights concerning the property would be set forth in the lease to the lessee. The co-owners' interests in the property likely would be viewed as interests in real estate in this scenario.

The foregoing should be contrasted with the situation in which the "co-owners" of property enter into both a co-ownership agreement among themselves and, moreover, hire a property manager to actively manage the property on their behalf. Even if the property generates only rental income, there is a significant risk that the relationship between the parties will be treated for tax purposes as a partnership (see the discussion below). And if a partnership return is filed, partnership tax treatment would almost always follow.[18]

LIKE-KIND EXCHANGES BY PARTNERSHIPS

The most frequently encountered problem in like-kind exchanges may involve the treatment of partnerships that own the relinquished property. It is exceedingly common when a partnership sells its property that one or more of the partners want to "cash out" in the transaction, whereas other partners want to reinvest through a like-kind exchange.[19]

EXAMPLE: Jack, Karen, Luke, and Mary are equal partners in partnership JKLM, the only asset of which is Whiteacre, a rental apartment building worth $10 million. Jack inherited his interest from his recently deceased parent, and Karen contributed $2.5 million to JKLM (which the partnership used for capital improvements) for her interest, so they each have a stepped-up basis in their partnership interests. Luke and Mary have a zero basis in their interests. JKLM made a Section 754 election, so the partnership has a $5 million basis in Whiteacre.

A buyer has offered to purchase Whiteacre for its FMV of $10 million, and all of the partners want to sell. Jack and Karen want to cash out with their share of the proceeds of the sale, but Luke and Mary want JKLM to purchase replacement property so as to defer gain recognition.

If JKLM sells Whiteacre to the buyer and half of the proceeds are given to a qualified intermediary and half are received by JKLM in cash (for distribution to Jack and Karen), the partnership will recognize $5 million of gain on the transaction, because gain is recognized to the extent of the boot received ($5 million in cash). If this gain were allocated equally to all of the partners, Luke and Mary would each recognize $1.25 million of gain but receive none of the cash; needless to say, this result would not be acceptable. There are at least three alternatives for resolving this situation.

Special allocations. Some partnerships have used a special allocation of the gain to the partners who cash out, i.e., the $5 million gain would be allocated to Jack and Karen. This gain

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17 See also McShain, 68 TC 154 (1977).

18 See TAM 199907029; see also FSA 199923017 and TAM 9504001.

19 For other issues related to this scenario, see generally Crnkovich and Lowy, "Planning for UPREIT Transactions When Selling Partners Want to Go Their Separate Ways," 90 JTAX 238 (April 1999).

would increase their basis in their partnership interests, so Jack and Karen also would have offsetting capital losses on the receipt of $2.5 million each from JKLM in redemption of their interests. (Of course, if any of the gain reflects depreciation recapture, Jack and Karen would have ordinary income and capital losses, which would not offset, resulting in adverse tax consequences.)

The problem with this approach is that it is not clear such special allocations have substantial economic effect. In this example, the gain allocation to Karen would increase her capital account to $5 million, but she would receive only $2.5 million from JKLM. Although the capital gain would be offset by a capital loss, resulting in no net tax liability to Karen, it is difficult to theoretically justify this special allocation under Section 704(b). The allocation of gain to Jack does not raise this issue if he has a zero capital account, although the offsetting gain and loss are also somewhat troubling. Furthermore, the presence of depreciation recapture will scuttle this approach long before it reaches the launching pad, due to the partners' inability to offset ordinary income with capital losses.

Distribution of undivided interests. Assuming that the gain cannot be specially allocated to the cash-out partners, many partnerships have distributed undivided tenancy-in-common interests in the property to their partners immediately before the sale. In our example, JKLM would distribute a 25% undivided interest in Whiteacre to Jack and Karen in redemption of their interests immediately before the sale, while Luke and Mary remain partners in the partnership. Alternatively, undivided interests could be distributed to all of the partners in liquidation of the partnership immediately before the sale to the buyer. Two issues arise:

1. Do the partners satisfy Section 1031's "held for use in a trade or business or for investment" test if they receive their undivided interests immediately before the sale?

2. Notwithstanding the dissolution of JKLM, does the relationship between the partners constitute a deemed partnership under Section 761, particularly if there is a significant level of activity involved in the operation and management of Whiteacre? And if the level of activity is minimized by reducing the amount of time that the property is held by the (former) partners as tenants in common, does that undercut their position with respect to the first issue?

There are no authorities that clearly confront these questions. With respect to the first issue, if Luke and Mary keep the partnership alive, there seems to be no question that they satisfy the "held for" test. Even if JKLM is liquidated immediately before the sale, however, several analogous authorities indicate that the "held for" standard would be satisfied.

In *Magneson*, 753 F.2d 1490, 55 AFTR2d 85-911 (CA-9, 1985), *aff'g* 81 TC 767 (1983), a taxpayer exchanged investment property for other like-kind property, and immediately thereafter contributed the replacement property to a partnership in exchange for a 10% general partnership interest. The court concluded that holding the property for contribution to the partnership was holding it for investment, and that the ownership of property as a general partner was not substantially different than direct ownership of the property. Similarly, in *Bolker*, 760 F.2d 1039, 56 AFTR2d 85-5121 (CA-9, 1985), *aff'g* 81 TC 782 (1983), the court permitted a like-kind exchange by a shareholder of a corporation who received the relinquished property immediately before the exchange through a nontaxable liquidation of the corporation.[20]

The problem is that these authorities are not completely on point, particularly because the partners (or more commonly now, the members of a LLC) will only rarely be general partners in a partnership. Furthermore, *Magneson* was decided when a tax-free exchange of partnership interests was permissible under Section 1031; Section 1031(a)(2)(D) altered that rule. Thus, there is at least some room for doubt that the "held for" requirement has been met if the partnership is liquidated.

The second issue also is a puzzling one. Logically, the distribution of undivided interests in the property should not result in a continuation of partnership, but the broad definition of an "entity" could pick up co-ownership of actively managed property. In some situations, this risk has been minimized by net leasing the property to a master lessee,[21] but this planning step is not always available. If such a net lease is not used, the determination of whether the partnership has remained in existence probably will depend on the facts and circumstances of the situation.

The lack of precedent notwithstanding, it is probably fair to say that this is the methodology most frequently used to deal with the common situation in which some partners want to reinvest and other partners want to cash out. There does not appear to be any policy reason why this transaction should be taxable to the reinvesting partners. After all, in our example Luke and Mary owned (through the partnership) an interest in real estate before the transaction, and they will own an interest in real estate (either directly or through the partnership) after the transaction. Why should they be subject to taxation when their economic position has not changed? For this reason, many practitioners have used this arrangement, although the more cautious ones have advised their clients concerning the risks involved (and, when possible, kept the partnership alive for the partners who want like-kind exchange treatment).

Installment notes. The third alternative, and one frequently used when there is a credit-worthy buyer of the relinquished property, is commonly referred to as the "installment note" method. Under this approach, the buyer conveys to the seller cash to be used

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[20] See also Maloney, 93 TC 89 (1989); Wagensen, 74 TC 653 (1980). But compare Barker, 668 F. Supp. 1199, 60 AFTR2d 87-5507 (DC Ill., 1987); Weintrob, TCM 1990-513.

[21] If the property is leased by the partnership to a master lessee on a triple-net basis, and undivided interests (subject to the master lease) are then distributed to the partners, it seems fairly clear that the co-ownership arrangement should not be recharacterized as partnership under Section 7701.

Practice Notes

Identification of replacement property in a deferred exchange can be problematic. The statute allows 45 days to identify the property and 180 days to close the deal, and the Regulations provide alternative three-property or 200%-of-FMV rules. If a taxpayer desires certainty, the three-property choice is the way to go: although questions occasionally arise about what is a "property," most of the time this is not a problem. The 200%-of-FMV rule, however, starts with the value of the relinquished property (presumably set in the sale at arm's length to the buyer), doubles it, and applies the total to the multiple properties under consideration by the seller as replacement property. Because no contracts have yet been entered into, there is room for doubt regarding the value of each such property, and whether the total of their FMVs will not exceed the 200% ceiling. Despite the "wiggle room," this may be the only option if a large partnership is involved, as discussed in the text.

for the purchase of the replacement property plus an installment note that could be distributed to the cash-out partners in liquidation of their interests.

Applying this method to our example, the buyer would convey to JKLM, in exchange for the relinquished property, cash of $5 million (which would be paid to a qualified intermediary) plus an installment note for $5 million. The note typically would provide for 98%-99% of the payments thereon to be made a short time after closing, with the remaining payments to be made after the beginning of the next tax year.[22] If the buyer is credit-worthy, no other assurances of payment might be needed; if there are questions concerning the buyer's financial ability to satisfy the note, a standby letter of credit might be obtained by the parties.[23]

This method "works" because no gain or loss is recognized by JKLM on receipt of the installment note. Furthermore, the distribution of the installment note to Jack and Karen in redemption of their interests in JKLM also would not result in recognition of gain under Section 453.[24] Instead, Jack and Karen would recognize gain only as payments are received on the note. JKLM, now comprising only the remaining two partners (Luke and Mary), would purchase replacement property, which clearly would qualify for tax deferral under Section 1031 because the partnership had held the relinquished property and acquired the replacement property.

POST-EXCHANGE DISTRIBUTION

The installment note method described is probably the "safest" method for a partnership to use to accomplish a like-kind exchange if the partners have different goals and desires (as discussed above, the primary alternative is to have the partnership distribute undivided interests in the to-be-relinquished property to its partners before the exchange). Nevertheless, in this transaction the replacement property is acquired by the partnership rather than the individual partners. This feature of the installment note method sometimes leads to other issues.

EXAMPLE: Luke and Mary, our remaining partners in the above example, both want to defer tax on the sale of Whiteacre by JKLM, but Luke wants to purchase Greenacre with his share of the proceeds while Mary wants to purchase Yellowacre with her $2.5 million. JKLM could purchase both properties, but could the partnership distribute the properties to the remaining partners immediately after the acquisition without adverse tax consequences?

Again, there is no guidance directly on this point. It generally is believed that *Magneson, Bolker,* and their progeny are support for the position that such a distribution does not violate the "held for" requirement in Section 1031(a).

There is a potential trap in this situation, however. The relinquished property was sold by JKLM, so any identification of the replacement property is tested at the partnership level. As a result, JKLM can identify only three replacement properties or properties with an FMV not in excess of 200% of the value of the relinquished property (Whiteacre). In contrast, if Luke and Mary directly owned their interests in the relinquished property, each could identify three replacement properties with complete safety. Thus, if Luke wants to acquire Greenacre while Mary wants to purchase a portfolio of six properties, the three-property identification rule would be violated and the 200%-of-value rule would have to apply.[25] This can create practical uncertainty for the partners, but it appears to be a small price to pay for certainty that the exchange is nontaxable under Section 1031.

CONCLUSION

The rules concerning like-kind exchanges are complicated, and there are many potential danger areas. Over time, however, practitioners have developed strategies to deal with many of the practical problems that frequently arise. One hopes the IRS will eventually issue guidance that "blesses" these common transactions. ■

NOTES

22 Under Section 453(b)(i), an installment sale is any sale in which one or more payments is to be made in the following tax year.

23 A standby letter of credit is not treated as payment under Temp. Reg. 15A.453-1(b)(3)(i). Because most of the payments on the note will be made shortly after the closing, the cost of the standby letter of credit usually is not significant.

24 The redemption of the interests of Jack and Karen, who own 50% of JKLM, does not terminate JKLM under Section 708(b)(1)(B) because a redemption is not treated as a "sale or exchange" for this purpose.

25 The problem is even worse if there are more than three partners who wish to defer gain; in that event, if each partner wants to receive a different replacement property, the partners have no choice but to apply the 200%-of-value rule.