Section 1031 Like-Kind Exchanges and Entity Considerations

By Robert S. Barnett

Like-kind exchanges have become increasingly common. Individuals and entities utilize IRC section 1031 like-kind exchanges to defer tax from the sale or transfer of real property. Individual shareholders and partners often desire different results; some seek to participate in the like-kind exchange, while others desire to "cash out" of the entity. In the context of such transactions, individuals and their related entities may engage in various transfers, including corporate or partnership liquidations, asset dropdowns, or contributions. This article examines these transactions in order to provide an understanding of some of the tax issues involved in structuring such like-kind exchanges.

The primary purpose of IRC section 1031 is to provide taxpayers the opportunity to exchange property that they hold for business or investment purposes for similar property that they intend to hold for the same purposes. IRC section 1031(a) states that no recognition of any gain or loss is required if "property held for productive use in a trade or business or for investment ... is exchanged solely for property ... which is to be held for productive use in a trade or business or for investment" (emphasis added). Transfer of retained investment property for similar investment property to be so retained is the touchstone of any successful section 1031 exchange. One recent case defined the inquiry as whether "the taxpayer's economic situation is in substance the same after as it was before the transaction" (Maloney v. Comm'r, 93 T.C. 89 [July 25, 1989] 62 F.3d 396 [Fifth Circuit 1995]). The taxpayer must remain invested in the same kind of property and not express any intent to liquidate or to use the property for personal purposes. Because the central controversy in exchange transactions is whether the holding requirement is met, each such exchange must be examined on its own merits. Proper documentation and observance of the formalities of the exchange transaction become paramount in planning and executing successful section 1031 transactions.

Nonrecognition for Dropdown Property

An entity may distribute or "drop down" property to its members prior to an exchange. In transactions like these, the individuals may decide whether or not to participate in the like-kind exchange or to cash out of their investment. The IRS will determine whether such transactions qualify for tax deferral.

The lack of a clear statutory definition of what constitutes holding property for business purposes or for investment has created uncertainty as to whether IRC section 1031 tax treatment is permitted for real estate previously distributed from a partnership or corporation. The uncertainty surrounds whether a distribution proceeding an exchange violates the requirement of holding the real estate for business or investment. The IRS has historically contested such transactions, claiming that the taxpayer's real intent was to liquidate the property or to use it for personal purposes, not to hold it for investment or business purposes.

For example, in Revenue Ruling 77-337, 1977-2 C.B. 305, the IRS took the position that tax nonrecognition was unavailable to a shareholder in a reorganized IRC section 333 corporate liquidation. As a result of the liquidation, the corporation's sole shareholder received corporate-owned real property and subsequently entered it into a like-kind exchange. The IRS refused to attribute the corporation's use of the property to its shareholder and, as a result, the "held for productive use in a trade or business or for investment" requirement under section 1031(a)(1) was not met.

IRC section 1031(a) specifically mandates that the property held for productive use in a trade or business or for investment be exchanged for similar property that is to be held for productive use in a trade or busi-
ness or for investment. Thus, any distributions of property by a partnership or by a corporation prior to an exchange must not contravene the requirement that the property be held for business or investment purposes, both before and after the exchange. The implications of this terminology are unclear in instances involving a change in property ownership. The IRS takes a very narrow interpretation of the statutory requirement. Fortunately, the courts have generally not followed the IRS’s restrictive interpretations. A review of the case history and the factors that courts have focused upon provides helpful guidance in structuring such transactions.

The Tax Court in Bolker v. Comm’r refused to follow Revenue Ruling 77-337 and determined that real property distributed in a corporate liquidation was held by the taxpayer for investment (81 T.C. 782 [October 20, 1983], aff’d 760 F.2d 1039 [Ninth Circuit 1985]). The Tax Court opined that “[a] trade of property A for property B, both of like-kind, may be preceded by a tax-free acquisition of property A at the front end, or succeeded by a tax-free transfer of property B at the back end.” Thus, the court determined that the relinquishment by the taxpayer of the corporation’s stock for the corporation’s real property was “essentially the same investment” and entitled the taxpayer to subsequently exchange this property in a section 1031 transaction. The Tax Court ruled in favor of the taxpayer, despite the fact that the exchange agreement was entered into upon the liquidation. The Bolker court found that there was no prearranged plan for a section 1031 exchange and was positively influenced by the fact that the property was held by the shareholder for three months prior to the exchange. In Bolker, the Tax Court was also influenced by the fact that the exchange negotiations were performed by the individual shareholder and not by his corporation.

The Ninth Circuit Federal Court of Appeals upheld the Tax Court’s opinion in Bolker on the grounds that the plain meaning of the statute mandates only that property be held for business or investment purposes, not that the taxpayer intends to hold the property indefinitely. The court stated that “if a taxpayer owns property which he does not intend to liquidate or use for personal pursuits, he is ‘holding’ that property ‘for productive use in trade or business or for investment’ within the meaning of section 1031(a).” Again, interpreting whether the taxpayer held the property within the meaning of the statute, the court focused on the taxpayer’s intent by examining the taxpayer’s statements and behavior. (In Bolker, both the Tax Court and the Ninth Circuit took support from Magneson v. Comm’r, 81 T.C. 767 [October 20, 1983], aff’d 753 F.2d 1490 [Ninth Circuit 1985], discussed further below.)

The trend of upholding section 1031 like-kind exchanges was followed in Mason v. Comm’r (T.C. Memo 1988-273 [June 27, 1988], aff’d 880 F.2d 420 [11th Circuit 1989]). In Mason, a partnership distributed real estate to its partners in liquidation of their interests. The taxpayer and his partner then exchanged their interests in the distributed real property immediately following their receipt of these parcels from the partnership. The IRS attacked this exchange, asserting that the transactions were part of a plan to exchange partnership interests and claiming that a sale had occurred.

The Tax Court held that the transaction was an exchange of property in an individual capacity and not by the partnership. The court made its determination on the grounds that the taxpayer and his partner received pro rata distributions of the real property and that the property interests subsequently exchanged were of like-kind between the former partners. The court upheld the characterization of the transaction for “federal income tax purposes as a pro rata distribution of partnership assets in liquidation pursuant to section 731 followed by a like-kind exchange pursuant to section 1031(a).” (It is important to note, however, that the court upheld the section 1031 exchange in Mason, even though it determined that the taxpayer received boot in the section 1031 exchange.) The 11th Circuit Court of Appeals affirmed the Tax Court’s decision without a written opinion.

Post-Section 1031 Dropday

The holding and rationale in Bolker was followed by the Tax Court in Maloney v. Comm’r. In Maloney, a corporation engaged in a section 1031 exchange approximately one month before disbur-
exchange. These facts indicated that the taxpayers were not the “direct owners” of the property prior to the exchange. Furthermore, the court noted that the partnership agreement clearly prevented limited partners from receiving distributions of property other than cash from the partnership. Because the partnership never received the exchanged property, the court also rejected the taxpayers’ assertion that their partnership had acted as their agent.

The *Chase* court noted several useful observations that should be avoided in structuring partnership distributions and like-kind exchanges of property (citations omitted):

- The petitioners did not act as owners, except in their role as partners.
- The deed to the individuals remained unrecorded until shortly before the disposition.
- The individuals did not personally negotiate the transaction other than in a partnership capacity.
- The petitioners never paid any of the operating costs or their share of the brokerage commission.
- The petitioners did not receive any of the rental income.
- The parties ignored petitioners’ purported interest as direct owners.
- The petitioners received only their partnership distributive share.
- The limited partnership agreement provided that no limited partner could demand and receive property other than cash from the partnership.
- The other limited partners were not even aware that such a distribution had occurred.

From these observations, the court concluded that the taxpayers were not the direct owners of the property that they purported to exchange in a section 1031 transaction.

The court’s observations in *Chase* provide helpful guidance in structuring section 1031 transactions that are preceded by a partnership distribution. Documentation must clearly demonstrate that the same taxpayer is the owner of the exchanged property, both before and after the exchange. This suggests that if the partners claim to have received an ownership interest in real estate from the partnership, they should properly record such receipt and pay for and negotiate all of the steps of the subsequent section 1031 exchange on their own behalf. Moreover, any partners attempting to arrange such a transaction should make sure that it is permitted by their partnership agreement. In a similar manner, corporate minutes should not reflect the section 1031 exchange if the transaction is to be accomplished by the individual shareholders after a dropdown.

**1031 Exchange Prior to Entity Contribution**

In Revenue Ruling 75-292, 1975-2 CB 333, the IRS asserted that an individual’s transfer of replacement property to a wholly owned corporation would fail to meet the “held for” requirement. The IRS reached its conclusion from the fact that the replacement property was not being held by the taxpayer who effected the exchange, but by his corporation. In *Magneson*, however, this ruling was not followed in a partnership transaction.

In *Magneson*, the taxpayer first completed a like-kind exchange immediately prior to contributing the exchanged property to a partnership. The IRS asserted that the taxpayer had not in fact held the property for investment purposes, because the exchange of properties was immediately followed by a contribution to a partnership. The Tax Court sustained the like-kind exchange under section 1031. It stated that “the taxpayer’s economic situation after the exchange ... [was] fundamentally the same.” The court opined that the transfer to the partnership was essentially a continuation of the investment because the transfer was simply a change in form of ownership which did not trigger any gain or loss or accelerate any reporting requirements. The *Magneson* court also noted that the petitioner’s basis in the exchanged property remained the same, since it was a nontaxable contribution to a partnership. Hence, the court in *Magneson* held that the subsequent transfer of exchanged property to a partnership under IRC section 721 did not interfere with section 1031’s requirement that the property be held for business purposes or for investment.

The Ninth Circuit Court of Appeals affirmed the Tax Court’s decision on slightly different grounds. The Court of Appeals determined that the differences between control and management rights of the taxpayer’s general partnership interest received in a section 721 contribution to a limited partnership and fee ownership in real property was not significant enough to deny nonrecognition treatment under section 1031(a). The Ninth Circuit held that the “critical attributes in the taxpayer’s relationship to the property are those relevant to holding the property for investment.” Although the court noted that there are differences between general partners and fee owners regarding management and rights of alienability of the property, the partnership’s purpose to hold the property for investment satisfied the statutory requirement, despite the fact that the transfer to the partnership occurred immediately after the section 1031 exchange.

**Prearrangements**

Several of the IRS rulings and cases discuss the impact of prearrangements in section 1031 transactions. Prearrangements are generally thought of in the context of the step transaction doctrine, which treats separate integrated transactions as steps or interdependent parts of a single transaction. Binding commitments are generally viewed as prearranged parts of a single transaction. If the steps and conclusion are interdependent, the courts generally collapse the various steps. In Revenue Ruling 77-337, the IRS asserted that a corporate liquidation followed by an individual shareholder’s exchange of the distributed property failed to meet the holding requirement. The essence of the IRS’s determination was that corporate holding of the property should not be attributed to the shareholder and that, therefore, the shareholder would not have held the exchanged property prior to the exchange for the new property. The Ninth Circuit in *Bolker* acknowledged the scarce authority on the subject. The court was influenced by two dispositive factors: 1) the corporate liquidation was planned before the shareholder ever intended to exchange the distributed property, and 2) the taxpayer actually held the distributed property for three months prior to the exchange transaction. (The court in *Bolker* claimed that it did not consider the step transaction doctrine in its examination of the liquidation and 1031 exchange because the IRS did not raise the argument before the Tax Court.)

The formalities of *Bolker* should be carefully studied, and any subsequent exchange
should not be contemplated prior to any entity liquidation or contribution. The missteps of the taxpayer in *Chase* should be similarly avoided.

**Guidance from Court Cases**

Although the above analysis provides much guidance for careful planners, the IRS has not yet expressly approved section 1031 transactions involving transfers to or from corporations or partnerships. The courts, however, have been more accommodating where the transactions have demonstrated a clear intent to hold the property for investment and the parties, in fact, continued to do so. The courts tend to look at the nature of the transaction and the character of the entity involved. Time permitting, enough distance should be maintained and binding obligations should be avoided. This will help to minimize any assertions by the IRS that a step transaction has taken place.

The transaction should be structured in a manner that preserves its nontaxable treatment. The formalities of the section 1031 exchange and related entity transaction should be well-documented and accomplished in a tax-free manner. In addition, the parties' respective interests in the real estate should remain the same throughout the transactions. This will help demonstrate that the transactions were merely a change in form and not in substance.

Moreover, based upon *Chase*, any drop-down distributions (or contributions) should occur as a separate transaction—apart from the section 1031 exchange—be duly authorized, and effectively transfer title to the property. In addition, the administrative drafting and recording of the deeds should be properly completed. Taxpayers and their advisors must determine the requisite tax return disclosure. Each transaction will have its own factors, and specific guidance must be based upon the unique facts and circumstances involved.

The above discussion describes transactions common to both corporations and partnerships, but is not intended to provide a general discussion of section 1031 exchanges. Due to the legal complexities involved in section 1031 transactions, there is no way to be certain that any particular transaction will be respected or challenged by the IRS.

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