

Dig: 1031

By David Borinsky¹

Dig: I'm Jewish.

Count Basie's Jewish.

Ray Charles is Jewish.

Eddie Cantor's goyish.

B'nai Brith is goyish; Hadassah, Jewish. Marine corps--heavy goyim, dangerous.

Kool-Aid is goyish.

All Drake's cakes are goyish. Pumpernickel is Jewish, and, as you know, white bread is very goyish.

Instant potatoes--goyish. Black cherry soda's very Jewish. Macaroons are very Jewish--very Jewish cake. Fruit salad is Jewish. Lime jello is goyish.

Lime soda is very goyish.

Trailer parks are so goyish that Jews won't go near them.

All Italians are Jewish.

If you're from New York, you're Jewish, even if you're Catholic.

If you're from Butte, Montana, you're goyish even if you're Jewish.

Lenny Bruce (1926-1966) 'Beat' era stand-up comic

¹ David Borinsky is managing member of Bridge Private Lending, LLC, a private real estate lender. He is also of-counsel to Gordon, Feinblatt, Rothman, Hoffberger & Hollander, LLC, a Baltimore, Maryland law firm. Tel: 443-722-2646/dborinsky@bridgeprivatelending.com

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The Internal Revenue Code is goyish. S Corps are goyish. Alternative minimum tax is goyish. Qualified retirement plan rules are *very* goyish.

But not everything in the Internal Revenue Code is goyish. Without question, partnerships are Jewish, as are capital gains. While trust income taxation is, on the whole, goyish, grantor trusts are Jewish. Estate and gift taxes are like someone who was raised as a Gentile, but who always felt Jewish. As for ordinary and necessary business expenses, well, can anything be more Jewish than the write-off rules of Section 162?

Like-kind exchange rules started out as goyish, but are trending Jewish. And therein lies the beginning of understanding of why a single Code section, Section 1031, persists in confounding tax planners and real estate professionals at every level of experience.

Take for example the requirement that both the relinquished property and the replacement property in a like-kind exchange be ‘held for investment.’

[transition]

I call upon you to suspend disbelief and assume that the *held for* issue breaks down neatly into three **discrete** problems.

The first is the “shovel in the ground” problem. Phrased as a question, when do value enhancing actions, such as installing sewer and water infrastructure, constitute a change in motive from investment to held for sale?

The second is the “guilt by association” problem. Phrased as a question, when are the activities of an entity’s owners or affiliates attributed to the entity for purposes of discerning whether property is held for investment or for sale?

The third is the “tax shoes” problem. Phrased as a question, when the taxpayer transfers either relinquished or replacement property to affiliates immediately before or immediately after an acquisition or disposition, does the transferee inherit the investment motive of the transferor?

This article will be published in three parts. This is part one, which discusses the shovel in the ground problem. Parts two and three, concerning guilt by association and stepping into the tax shoes of an affiliated transferor, will be published in subsequent issues of *Tax Talk*.

The Shovel in the Ground Problem

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Few cases relevant to the shovel in the ground problem turn on the question of whether or not the taxpayer actually stuck a shovel in the ground, that is, installed infrastructure. As a result, rather than combing the lawbooks for a color-coded guide to the matter or a secret map, let's begin with first principles -- in this case, the definition of investment property.²

The relevant regulation under IRC Section 1031, Treas. Reg. § 1.1031(a)-1(b), refers to investment property as property held “by a non-dealer for *future use or future realization* of the increment in value.” Similarly, the Tax Court has described investment property as property held with the intent to realize “appreciation in value accrued over a substantial period of time.”³ The owner, in other words, cannot look to improvements it makes to create gain on resale.⁴ These attempts at a definition bespeak an essentially passive relationship between a piece of property and its owner.

The problem of line drawing (given the inconsistency of caselaw, one might cynically call it mind reading) arises when a passive owner takes steps to liquidate the investment. By definition, even the most slug-like passive owner is at this point holding his or her property for sale. How to distinguish, therefore, the tax-favored slug from the enterprising, value-creating entrepreneur who, for his trouble, must pay an additional twenty percent of his profits to the government?

Although the caselaw defies easy categorization, it is clear that there is no *per se* rule against owners of investment property attempting to enhance the value of their property or to otherwise position it for sale.⁵ As the Tax Court put it in *Buono v. Commissioner*,⁶ “this blanket interdiction of capital gains treatment where there has been any laying on of hands is belied by the past decisions of this court.”

In *Buono*, the IRS claimed that the taxpayer purchased property for the primary purpose of subdividing and reselling it. It argued, in addition, that the taxpayer's efforts to subdivide the property constituted a trade or business. According to the IRS, therefore, the property did not

² Section 1031 applies to property held for investment and to property held for productive use in a trade or business. This article focuses entirely on the former of the two categories.

³ *Howell v. Commissioner*, 57 T.C. 546 (1972).

⁴ *Jersey Land & Development, Inc. v. Commissioner*, 539 F.2d 311 (3rd Cir. 1976).

⁵ The taxpayer does bear the burden of proving the proper investment motive. *Click v. Commissioner*, 78 T.C. 225 (1982).

⁶ 74 T.C. 187 (1980), quoting *United States v. Winthrop*, 417 F.2d 905 (5th Cir. 1969).

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qualify as a capital asset, because the taxpayer held it primarily for sale in the ordinary course of its trade or business.⁷

The court agreed that the property had been purchased for the purpose of subdividing and reselling, but it concluded nonetheless that purchasing with that exit strategy in mind did not preclude the existence of an investment motive. It further stated that pursuing purely legal steps, such as subdivision, to enhance value does not defeat an owner's investment motive. The Court did observe that had the owner physically improved the lots it may not have prevailed on the held for investment issue.

There is a line of cases, in which *Buono* figures prominently, on the question of whether or not the sale of real estate is taxable at capital gains or ordinary income rates. These cases are relevant to the question of qualifying for deferral under the like-kind exchange rules, because the elements applicable to each, the capital asset question embodied in Section 1221 and the held for investment question embodied in Section 1031, overlap.

While the factors relevant to the two inquiries overlap, they are not identical. It is easier to qualify for capital gains treatment under Section 1221 than to qualify for like-kind deferral under Section 1031. Property flunks the capital asset test if three elements are present: the property is *primarily held for sale*, the seller is engaged in a *trade or business*, and the sale takes place *in the ordinary course* of that trade or business. In other words, it's possible for a taxpayer to hold property for sale, but to qualify nevertheless for capital gains on its sale, because the taxpayer was not engaged in the trade or business of selling that type of asset.

Bear in mind, therefore, when consulting the *Buono* line of cases, that a taxpayer can flunk the Section 1031 test – that is, not qualify for deferral – merely because the property in question is held for sale, *irrespective of whether or not* that taxpayer is in the trade or business of selling that type of property -- or any other type of property.⁸

This was the fate of the taxpayer in *Ethel Black v. Commissioner*,⁹ in which Ms. Black acquired as replacement property in a like-kind exchange a single family home which she spruced up and sold for cash. The court concluded that she had held the replacement property

⁷ IRC Section 1221(a)(1) provides that the term capital asset does not include property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

⁸ “[T]he words ‘for sale to customers in the ordinary course of’ the taxpayer’s trade or business are quite conspicuous by their absence” from Section 1031. *Bernard v. Commissioner*, T.C. Memo 1967-176.

⁹ 35 T.C. 90 (1955).

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for resale rather than for investment, and that therefore the sale did not qualify for deferral under Section 1031. The taxpayer had not acquired the replacement property, the court stated, with the intent of holding it as “an unliquidated continuation of the old property and for investment.”

In *Bolker v. Commissioner*,¹⁰ the Ninth Circuit stated that unless replacement property is acquired either for personal use or with the intention of converting it to cash or other not like-kind property, it is held for investment.¹¹ Under this rather lax “what is not prohibited is permitted” formulation of the ‘held for’ rule, one could argue that had Ms. Black taken title to the replacement property with the intent of exchanging *that* property for yet another which was to be held as a long term investment, she would have satisfied the held for standard articulated in *Bolker*.¹²

Because of the *Ethel Black* problem – and despite the taxpayer’s victory in *Buono* -- taxpayers who buy property with “subdivide and sell” on the brain generally lose when they try to defer the gain in a like-kind exchange. In *Jersey Land & Development Corp v. Commissioner*, a capital gains case, the court concluded, based on the taxpayer’s efforts to subdivide the property in question, that it had “looked to the extensive improvements it made to the property, rather than market appreciation, to create gain on resale.”¹³ Taxpayers get nailed when they ‘look to extensive improvements’ rather than waiting ‘for value accrued over a substantial period of time.’

Despite allowing capital gains in *Buono* based on a finding that the taxpayer held the property for investment rather than for sale, the court seemed to take comfort in the existence of the additional line of defense found in Section 1221 – the ‘was there a trade or business’ question. A conclusion on that issue, however, was not essential to the resolution of the case. In other words, stripped of the “trade or business’ *dicta*, *Buono* is really just a better dressed version of *Ethel Black*.

¹⁰ 760 F.2d 1039 (9th Cir. 1985).

¹¹ In *Click v. Commissioner*, 78 T.C. 225 (1982), the Tax Court ruled that replacement property was not held for investment because the taxpayer had intended from the day it acquired it to gift it to her children, which she in fact did several months later.

¹² An interesting case on this issue is *Bernard v. Commissioner*, T.C. Memo 1967-176, in which the purchaser of the taxpayers’ relinquished property insisted that the taxpayer accept payment in kind, that is, like-kind property. Although the taxpayers briefly farmed the replacement property, the record showed clearly that they had no intention of holding it with the intent of realizing, as the Tax Court put it in *Howell v. Commissioner*, “appreciation in value accrued over a substantial period of time.”

¹³ 539 F.2d 311 (3rd Cir. 1976) (Note to self: recommend that developer clients not include the phrase “Land & Development” in company names.)

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Or is it? One detects an unstated premise in *Buono*, as well as in other cases addressing the question of whether or not a property was held for sale for *capital gains* purposes. Specifically, there is a tendency to conclude that property is held for sale if a court finds that the taxpayer is engaged in a trade or business, and, conversely, to conclude that a taxpayer lacks the motive to sell *because* it is not engaged in a trade or business. Despite the actual language of the case, therefore, *Buono* is less of a win than it appears for taxpayers seeking to qualify a transaction for deferral under Section 1031.

If *Buono* is a better dressed version of *Ethel Black*, then perhaps it can be said that *Neal T. Baker Enterprises, Inc. v. Commissioner*¹⁴ is *Buono* mugged by reality. The issue in *Baker* was whether or not the taxpayer could defer gain under Section 1031 on the exchange of land previously held for sale in the trade or business of creating and selling residences and residential lots. The taxpayer in *Baker* developed and owned commercial properties and had a history of developing residentially zoned land into building lots.

Despite its initial intent to hold the property in question for sale as subdivided lots, the taxpayer argued that changed economic conditions and other events beyond its control caused a change in motive by the time it unloaded building lots to a homebuilder. Unfortunately for *Baker*, the court concluded, in effect, that the critical mass of ‘dealer’ facts was too great to overlook (not least the fact that the taxpayer had carried the property in question on its books for years as ‘work-in-progress’). Result: no Section 1031 deferral of gain.

Baker is, in a sense, an anachronism in a tax environment that includes corporate level gain on distributions of appreciated property and the opportunities for tax flexibility ushered in with limited liability companies and the check the box rules. All the same, this case brings to mind a client’s favorite comment to me when the going got tough: “I may be dumb, but I’m not stupid.” The courts get a lot of these cases wrong, but clients need to appreciate the likelihood of a *Baker*-like outcome at the IRS administrative level and before some courts.

Regarding the laying on of hands, other taxpayers have engaged in more extensive development activities than the taxpayers in either *Buono* or *Baker* and still qualified for capital gains. Each case, however, involved other counterbalancing factors indicating investment motive.

¹⁴ T.C. Memo 1998-302.

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These counterbalancing factors include the original purpose of the acquisition, the frequency and continuity of sales and the extent of presale development and marketing activity.¹⁵ No one factor is controlling, but all are relevant.¹⁶ Courts allow the longest leash on these other factors when the taxpayer has held the property for a long time or when events beyond the control of the taxpayer intervene to dictate a change in business strategy.

For example, in *W.T. Thrift v. Commissioner*,¹⁷ the taxpayer owned property for five years before being approached by builders looking to purchase finished lots. The taxpayer subdivided the land and installed infrastructure, selling the lots in groups to several builders over a short period of time. The Tax Court concluded that the gain on those sales was taxable at capital gains rates, reasoning that the subdivision and infrastructure activity were merely preparatory to maximizing liquidation of the five-year old investment.

Thrift teaches us that you can get away with shovel in the ground activity if you begin with an unassailable investment-like motive in purchasing the property and if you hold the property in that status for some period of time. “There will be instances,” as one court put it, “where an initial investment purpose endures ... notwithstanding continuing [development].”¹⁸

Regarding events beyond the taxpayer’s control, in *Erfuth v. Commissioner*,¹⁹ a taxpayer in the business of constructing and operating rental properties converted one of its projects to condominiums under threat of foreclosure. The court ruled that gain from unit sales was taxable at capital gains rates because the threat of foreclosure was an “unanticipated, externally induced factor...which ma[d]e impossible the continued pre-existing use of the realty.”²⁰ Interestingly, the court ruled that sales of units after the threat of foreclosure had passed were taxable at ordinary income rates.²¹ Despite the kick in the pants on the post-foreclosure sales, *Erfuth* teaches us that the taxpayer wins when events outside his or her control force a shift in business strategy.

¹⁵ *Adam v. Commissioner*, 60 T.C. 996 (1973).

¹⁶ *Id.*

¹⁷ 15 T.C. 366 (1950).

¹⁸ *Biedenharn Realty Co. v United States*, 526 F.2d409 (5th Cir. 1976).

¹⁹ T.C. Memo 1987-232.

²⁰ Quoting *Biedenharn*, *supra*.

²¹ Given the Tax Court’s own prior decisions in this area, it was probably too tough on the taxpayer regarding the post-foreclosure threat sales. It is unreasonable to expect a sophisticated, high volume apartment developer to hang on to an odd group of here and there condominium units.

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Similarly, in *Paullus v. Commissioner*,²² a corporate taxpayer which was primarily engaged in the business of developing golf courses subdivided residential land adjacent to one of its projects and completed some in-ground improvements prior to selling. The taxpayer argued that the in-ground improvement had been installed at the request of the buyer, rather than in advance of seeking buyers. It also argued that the property was held for investment at the time of sale because the seller had an exogenous reason for selling: the need to raise capital to fund its primary business.²³

Paullus is a kind of ‘advanced placement’ version of *Thrift* and *Erfuth*. In addition to teaching us the value of an unassailable investment-like purchase motive, it can be mined for lessons relating to physical improvements and for what constitutes an event beyond the control of the taxpayer.

Regarding physical improvements, while there is no ‘blanket interdiction’ on physical improvements, the installation of infrastructure is a factor to be weighed. Indeed, it would likely prove the decisive factor in an otherwise close case. The taxpayer in *Paullus* disarmed the problem by casting it as a buyer requested act. In other words, installing infrastructure reflected the intent of the buyer, according to the taxpayer, rather than that of the seller.

In a fairly recent case, the taxpayer succeeded in extending the ‘buyer made me do it’ logic of *Paullus* to affiliates of the seller. In *Phelan v. Commissioner*,²⁴ an affiliate of the owner of the property installed infrastructure on the property in question. The court didn’t attribute the infrastructure activity to the taxpayer, reasoning that the related party had its own business motives and faced its own business risk.

In fact, while the affiliate was obligated on substantial bond obligations which would have gone into default if the affiliate had not completed the infrastructure, it was obvious that the affiliate would not have put itself at risk on the bonds had the commonly controlled company not owned the land at issue. One could easily say that the IRS had the better of the argument on the issue. Perhaps the IRS just got outlawyered, or perhaps this case is the fruit of the Tax Court’s

²² T.C. Memo 1996-419.

²³ The taxpayer in *Baker*, *supra*, also claimed that its need to raise capital removed the ‘held for’ taint from its sale of investment property, although it failed to convince the Tax Court.

²⁴ T.C. Memo 2004-206.

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iffy reasoning in *Buono*. In any event, it's a good case for taxpayers on the shovel in the ground issue.²⁵

Just as the Tax Court seemed determined to go the taxpayer's way in *Phelan*, the IRS itself, in PLR 9337027, seems to have lost its focus in addressing what constitutes an event beyond the control of a taxpayer. According to the facts recited in PLR 9337027, a religious order planned to subdivide surplus property that it had owned for seventy years into 75 or 80 lots, as well as to install infrastructure. In the words of the ruling, the owner planned to install "the minimum physical improvements necessary to sell the lots to *individual* purchasers."²⁶ (emphasis added)

The organization wanted to sell the otherwise unused land to meet a funding gap caused by a decrease in other revenue sources. It proposed doing its own development, moreover, and involving itself in sales, even including hiring a broker. The IRS found it relevant, somehow, that the seller involved itself so deeply in the disposition of the lots "in order to maintain a quiet, peaceful environment consistent with its continued use of the [adjacent property]." Amazingly, the IRS concluded that the plan qualified as a "one time liquidation of an investment asset" rather than the conduct of a trade or business.

In the case of an event beyond the control of the taxpayer, can IRS absolution be based on a *funding gap*? That's the argument to be had from both *Paullus* and PLR 9337027. In fairness to the IRS, the actual issue in the letter request from the religious order did not involve the question of capital gains. Instead, it involved whether or not the organization would be subject to the unrelated business taxable income tax. Although the IRS relied heavily on capital gains cases to reach its conclusion, the result likely reflects a measure of tolerance for transactions, which, while marginal tax-wise, do not tend to invite abuse. In *Paullus*, however, the court did cite funding needs as a factor tending to show an "enduring" investment motive.²⁷

²⁵ Tie in *Buono* and *Ethel Black*

²⁶ The property owner, a tax-exempt organization, sought an advanced ruling on the issue of whether the profits from the sale would be taxed as unrelated business taxable income. However, as the IRS acknowledged in the ruling, caselaw on the capital gains issue bears directly on the issue of unrelated business taxable income.

²⁷ Although not emphasized in the *Paullus* opinion, the lot development activities complemented the taxpayer's primary, golf course development business. In that sense, *Paullus* resembles the private letter ruling concerning the religious order, as the religious order had argued that its need for development compatible with its continuing activities on neighboring land justified an unusual level of involvement in development activities.

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When it comes to outside events, *Charles R. Gangi v. Commissioner*²⁸ occupies something of a middle ground between the wobbly “funding gap” theory of *Paullus* and PLR 9337097 on the one hand and the foreclosure drama faced by the taxpayers in *Erfurth* on the other. The taxpayer in *Gangi* owned a multi-family project for almost ten years and then converted the project to condos and sold out because of the deterioration of the owners’ business relationship. The owners advertised, although only to a limited extent, and maintained a sales office. The court took some comfort in the fact that the owners had not made any structural improvements on the property and had incurred minimal brokerage expenses.

It is not cynical to suggest that practitioners should ponder whether it is feasible to tease out a funding gap or deterioration of business relationship argument when their own clients are challenged on the ‘held for’ issue.

Although a detailed examination of the shovel in the ground problem yields some planning insights, it is more retrospective and diagnostic in nature than the discussion to come of the attribution issue (guilt by association) and the matter of transfers immediately before or immediately after an exchange (tax shoes). That makes sense; because the client only looks for tax advice on a like-kind exchange around the time he or she contemplates doing one. The challenge of determining whether the property in question has been held for sale or held for investment is, at that point, more in the nature of an historical inquiry than a planning task.

Parts two and three, covering the guilt by association problem and the tax shoes problem, will yield more in the way of planning prescriptions and opportunities.

The Guilt by Association Problem

The Tax Shoes Problem

Dealing with like-kind exchanges when one or more owners wish to reinvest under Section 1031 and one or more wish to cash out is an unpaved stretch of the like-kind superhighway. Dealing with partnerships in which *all* partners wish to reinvest, but wish to do so separately from their current partners, is an especially rutted portion of this unpaved stretch.
[return to both points in conclusion]

Special allocation of gain to the cashing out partner doesn’t work, because the point of a like-kind exchange is to defer rather than to specially allocate gain. An installment sale to the

²⁸ T.C. Memo 1987-561.

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retiring partner works, the step transaction taint notwithstanding, but only with the right facts. Transfers of part interests in relinquished or replacement properties either immediately before or after a sale or purchase²⁹ not only reek of step transaction, but fly in the teeth of the requirement that each of the relinquished and replacement property be held for investment by the same taxpayer. Besides, even a tenant-in-common arrangement can look like a de facto partnership to a distrustful, determined IRS.

What to do? Listen to the courts. The huffing and puffing of the IRS notwithstanding, courts have ruled for the taxpayer in each case involving the issue of transfers to or from the tax partnership in connection with a like-kind exchange.

Courts have done a poor job, however -- or, more charitably, have struggled with the difficult issue -- of formulating a principle around which consistent planning and court decisions can flow. The issue is not only critical to determining a taxpayer's investment or non-investment motive in the context of like-kind exchanges but is also relevant to tax minimization strategies which do not involve Section 1031.

When property is transferred immediately before or immediately after a step in the like-kind exchange, the taxpayer typically would like to see an attribution of motive, the "tax shoe" issue discussed below. In contrast, partnerships, and LLC's taxed as partnerships sometimes attempt to lock in appreciation at capital gains rate, and yet still dispose of the asset in the form of inventory, such as building lots, finished homes or apartment units.³⁰ Consequently, taxpayers and their tax advisors can find themselves on both sides of this attribution issue. What is necessary, therefore, is not only a path "in" to the held for investment promised land, but also a proper boundary survey of the premises, for those instances in which it serves the client to steer clear of the 'held for' status.

The issue, broadly stated, is whether the transferee steps into the "tax shoes," as Congress and the IRS have phrased it, for purposes of satisfying the held for investment requirement.

²⁹ Drop and swaps, or swap and drops, as Richard Lipton called them in *The State of the Art in Like-Kind Exchanges*, 2006, *Journal of Taxation*, March 2006.

³⁰ This involves selling the project in gross to an affiliated corporation, and having the corporation engage in the final stages of development prior to sell out. If the trade or business activities of the purchasing corporation are attributed back either to the selling partnership or to its owners, then the gain on the sales from the partnership to the corporation should be taxed as income ordinary rates

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Tax shoes don't wear as well in the world of corporations as in the world of partnerships. In Rev. Rel. 75-292, the IRS examined the question of whether the taxpayer in a section 1031 transaction could transfer the replacement property to a corporation immediately after closing out the like-kind exchange [holding?]. Similarly, in Rev. Rel. 77-337, IRS ruled that the sole shareholder in a corporation did not inherit the corporation's held-for investment status with respect to the property distributed to him in liquidation of the corporation.

But even with corporations, there is not much bad news out there beyond those two revenue rulings and a stray, somewhat dated Tax Court opinion.³¹ In *Maloney v. Commissioner*,³² a corporation exchanged like-kind properties and immediately thereafter transferred the replacement property to its owners in complete liquidation. The IRS argued that the intent to liquidate and distribute profit to shareholders was akin to an intent to sell the property or to gift it. The court disagreed, relying on *Magneson* and *Bolker*, discussed below, reasoning that the liquidation under old section 333 did not amount to a cashing out from the investment.

The court contrasted the facts in *Maloney* to those of *Regals Realty Co. v. Commissioner*.³³ In *Regals Realty*, the court found as a matter of fact that the corporate exchanger intended to sell the real estate which it had just received in a like-kind exchange and to distribute the proceeds in liquidation of the corporate taxpayer. While the corporation did not in fact sell the replacement property, and instead dropped it into a subsidiary and spun the subsidiary stock out to the shareholders, the court concluded that the taxpayer had intended to sell the property received rather than to hold it for investment. The court in *Regals* did, however note that even if the taxpayer's intention should have been gauged by what was actually done rather than by the expression of an intent, the drop down into the subsidiary and subsequent distribution to shareholder "made it impossible for [the taxpayer] to hold the property as an investment.

In response to the IRS' argument based on *Regal*, the *Maloney* court stated that "we need not decide in the instant cases whether we agree with the *Regals Realty's* alternative holding that a Section 351 transaction would be incompatible with a Section 1031 tax free exchange. In so

³¹ In *Brown v. Commissioner*, 448 F.2d 514 (10th Cir. 1971), the court ruled that the business of a corporation is not ordinarily attributable to its shareholders. [need to explain]

³² 93 T.C. 89 (1989).

³³ 43 B.T.A. 194 (1940).

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stating, the court might, ideally, have explained why it viewed as important the distinction between a transfer *from a corporation* and a transfer *to a corporation*. So there you have it on transfers between corporations and their individual shareholders immediately before or after completion of a like-kind exchange. [mention *Bolker*] The worse that can be said is that such transfers are not clearly impermissible. The best advice is to steer clear of the tangled thicket of cases involving transfers to and from corporations, advice that, in light of conventional real estate practices and the repeal of *Court Holding*,³⁴ is easy to follow.

In contrast to questions involving transfers to and from corporations, there is some coherence in evidence in the context of tax free reorganizations.³⁵ In PLR 9152010, a corporation exchanged relinquished properties and then merged with a REIT in a C Reorg, following which the successor corporation purchased the already identified replacement properties. The IRS reviewed the legislative history of the pertinent division, Section 381, noting that its legislative history “reveals that the purpose of Section 381 was to put into practice the policy that ‘economic realities rather than ... such artificialities as a legal form of the reorganization ought to control in the question of whether a tax attribute from an acquired corporation is to be carried over to the acquiring one.’” The ruling also notes legislative history under Section 1031 which justifies deferral under that provision because the taxpayer has not “cashed in” on the investment in the relinquished property.

Significantly, the ruling concludes by stating that the “policy concerns that gave rise to Section 1031 *are no less applicable* when the acquiring corporation filing a Section 368(a)(1)(C) reorganization receives like-kind replacement property.” Stating that the policy concerns under the tax free reorganization rules are “no less applicable” to those which give rise to like-kind exchanges is a significant confession on the part of the IRS.

In an equally generous spirit, the IRS issued PLR 9751012, which involved a deferred like-kind exchange initiated by a corporate member of a consolidated group. Prior to closing out the exchange, the corporation liquidated into its parent, and then its parent was merged into a brother-sister corporation as part of a tax-free reorganization. The ruling echoes the approving sentiments expressed in the 1991 private letter ruling discussed above toward the intent of

³⁴ [need cite]

³⁵ That makes some sense, in that transfers in and out of corporate solution -- that is, crossing the boundary between the corporate world and the non-corporate world -- implicates deeper policy issues concerning the purpose and integrity of the corporate tax rules.

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Congress under Section 381; that is, that successor corporations should be able to step into the “tax shoes” of a predecessor corporation. Significantly, Section 381 enumerates certain tax attributes that carry over to a successor corporation, but does not include the “held for investment” state of mind required for a proper like-kind exchange. The IRS concluded all the same that allowing for such a carry-over’s intent was consistent with the legislative purpose.

The *Magneson* and *Bolker* cases, decided by the Ninth Circuit in 1983 and 1985 respectively, are part of the founding myth that transfers immediately before and immediately after like kind exchanges are risky, high wire schemes. Like many founding myths, it sometimes pays to reexamine the primary text. Doing so in the case of *Bolker* and *Magneson* yields an interesting harvest of insight into this area of the law.

In *Magneson v. Commissioner*³⁶ the taxpayer took title to replacement property and then immediately contributed it to a partnership in exchange for a general partnership interest. The foundation of the court’s finding that Section 1031 applied was the continuity of interest and continuity of control. The court did note that a transfer to a corporation is different from a transfer to a partnership, because the change in the legal status is more pronounced in the case of transfers to corporations than is the case with transfers to general partnerships. Specifically, the court reasoned that a transfer to a partnership in exchange for a general partnership interest does not “significantly affect the amount of control or the nature of the underlying investment.” The court also rejected the government’s attempt to apply the step transaction doctrine, concluding that the steps taken were not circuitous.³⁷

So *Magneson* tells us that when you have good facts -- a partnership rather than a corporation and a carryover of all the incidents of control (that is, a general rather than a limited partnership interest) -- the investment motive of the transferor carries over to the transferee. The fault line does seem to boil down, under *Magneson*, to the intersection of corporations and partnerships. *[discuss change in law expressly prohibiting like-kind exchange treatment for partnership interests]*

³⁶ 753 F.2d 1490 (9th Cir. 1983).

³⁷ It is worth noting that this is more or less the last we have heard from the IRS in attempting to apply the step transaction doctrine in the context of transfers to and from entities before and after like-kind exchange. It does appear that arguing step transactions is unlikely to get the IRS out of the barn, in that in the typical swap and drop or drop and swap, there is no pretense about what is going on.

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Two years later, however, the same Ninth Circuit softened its position on corporations, ruling in *Bolker v. Commissioner*³⁸ that a corporate taxpayer could liquidate tax free, and the taxpayer could exchange the property received in the liquidation for like-kind property in a transaction qualifying under Section 1031. Despite facts involving the harder case of a transfer *from* a corporation, the court decided that in the absence of an intent to either convert the property to personal use or to liquidate it, that is, turn it into cash, the taxpayer could satisfy the held-for requirement.³⁹

The *Bolker* court also stated that the order of the Section 1031 exchange and the other transaction, standing alone, is “insufficient” to affect the result.

[*Need to tie-in consolidated/reorg provisions*]

The thrust of the case law, together with the more or less studied indifference of the IRS to the technique, suggests that taxpayers are fairly safe in using the swap and drop and drop and swap, provided they pay attention to the technical demands of the art.

The foremost technical demand of the art is to not treat a tenant in common interest distributed from a partnership (or limited liability company taxed as a partnership) as if the distribution never occurred. Note in this regard that the IRS and the courts, in both the tax and non-tax context, apply the *duck* rule to the question of whether or not an arrangement constitutes a partnership. If two or more parties join together for the purpose of carrying on a business and sharing profits and losses, it’s a partnership. *Culbertson v. Commissioner*,⁴⁰ and see *Madison Gas & Electric Co. v. Commissioner*,⁴¹ (check case name), in which the court ruled that a joint ownership arrangement involving electrical cogeneration constituted a partnership because of the extensive management activities required by the undertaking.

In the context of owning real estate, the issue -- provided the parties take care of the easy points such as *pro rata* sharing of debt -- comes down to the level of management. This in turn, involves both the question of (i) whether or not there is centralization of management, which by

³⁸ 760 F.2d 1039 (9th Cir. 1985).

³⁹ This brings to mind the old joke about how the starting premise of laws in Italy is that what is not prohibited is allowed, while in Germany, the starting premise is what is not expressly allowed is prohibited. The Ninth Circuit, more Italian than Germanic in its sensibility, opted for the broad permissive rule, that is, every kind of transfer immediately before and immediately after is permitted, provided there is no intent to do what is prohibited -- converting to the property personal use or turning it into non-like-kind property, such as cash.

⁴⁰ 337 U.S. 733 (1949).

⁴¹ 633 F.2d 512 (7th Cir. 1980).

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itself suggests a partnership, and (ii) whether or not management of the property in question requires activities over and above those normally seen in connection with straight rental property.

Rev. Rul. 75-_____ provides a safe harbor on this issue. In that ruling, unrelated parties owned equal tenant in common shares in an apartment building. The two owners entered into an agreement which covered the necessary points for managing the property, consisting of routine rental and maintenance matters, but no extraordinary management demands, such as those required by a hotel, senior housing or a parking garage. The IRS concluded that the arrangement lacked sufficient indicia of a partnership and therefore constituted a tenant in common relationship.

Another important area where competent advice given earlier in the process pays is on the question of who contracts with the outside parties. It is difficult, for example, for Partner A in what was formerly ABC Partnership to claim that his or her recently distributed tenant common interest in the partnership's real estate is truly an interest held separate from the partnership if ABC Partnership signs a contract to sell all the ownership interests in the property, and Partner A's name appears nowhere in the documents.

Ideally, the ownership group will hold itself out as separate owners, and most importantly, in connection with negotiating and executing a contract of sale, each tenant in common interest is separately represented and separately reflected in the documents. For example, in *Chase v. Commissioner*,⁴² a partnership distributed a tenant in common interest out to a partner in redemption of that partner's interest in the partnership. The transferee partner did not record the deed immediately. Instead, the partnership negotiated and concluded a contract with a purchaser, and held itself out throughout the negotiation and settlement process as the sole owner of the property. Pending settlement, for example, funds needed to manage the property were held solely in the name of the partnership. The redeemed partner, moreover, only recorded his deed once it was clear that the sale was going to take place.

The taxpayer argued that the partnership had been acting as his agent, but the court found no evidence that that was so. Instead it concluded that there had not been a true redemption or any other change of the relationship of the owners of the original partnership.

⁴² 92 T.C. 874 (1989).

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If, as happens sometimes, the partnership contracts only in its own name to sell the property, if at all possible, the contract should be rescinded and a new contract reflecting the names of all the tenants and common owners should be signed in its stead. That is not as good as getting it right the first time, but better than running afoul of the standard reflected in *Chase*.