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## Who Sold the Property? —Step Transactions in the Context of Involuntary Conversions

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Where real property is to be transferred by a partnership or other entity comprised of investors with differing goals, a common question is whether the transfer may be structured to permit one investor to defer gain by acquiring property of like kind in an exchange intended to qualify under Internal Revenue Code section 1031, while others receive cash proceeds and recognize gain.

Similar questions may arise where property is destroyed or condemned, and some but not all of the investors desire to acquire other property in a manner qualifying for nonrecognition of gain under Code section 1033. That section permits the gain from property which is destroyed, transferred pursuant to a condemnation, or sold under threat of condemnation to be deferred, if the owner purchases, within a specified period, property "similar or related in service or use" to the property converted and the cost of the replacement property equals or exceeds the amount realized from the disposition. With respect to the conversion of real property held for productive use in trade or business or for investment, any property "of a like kind" to the converted property, and which is also to be held for productive use in trade or business or for investment (the same requirements as apply for like-kind exchanges under section 1031) is treated as "similar" to the converted property for

purposes of the general nonrecognition rule of section 1033(a).

### Undivided Interests

Where property is held by an entity that is classified as a partnership for tax purposes, and some but not all of the partners want to effect transactions qualifying under sections 1031 or 1033, one tactic that may sometimes be availed of involves the distribution of undivided interests in the property to the partners. Each "tenant-in-common" may then agree to dispose of his interest, and those persons who wish to structure their dispositions as like-kind exchanges may attempt to do so; or, upon a sale of an undivided interest in connection with condemnation proceedings, may use his share of the proceeds to acquire replacement property.

Such pre-exchange or pre-sale distributions raise questions, however, as to whether the sequence of steps will be respected for tax purposes as a distribution by the partnership followed by a disposition by the partners; and whether the partners hold the interests so acquired with the business or investment purpose necessary to proceed with (i) an exchange qualifying under section 1031 or (ii) the reinvestment of cash proceeds from an "involuntary conversion" in property of like kind pursuant to section 1033.

### IRS Challenges

Taxpayers have won a number of skirmishes with the Internal Revenue Service on these issues. A recent IRS technical advice memorandum suggests, however, that the IRS will continue to challenge transactions involving pre-disposition restructurings where the case law and statute do not mandate a result favorable to the taxpayer.

**TAM 9645005.** A general partnership ("P") was formed to purchase undeveloped land. Each of the two partners, a limited partnership ("L") and a corporation, acquired a 50% interest in P.

Three years later, condemnation proceedings were initiated by the "Authority" (as referred to in the TAM) against a portion of the land, and a contract was ultimately executed to sell that portion (the "Property") to the Authority. The contract permitted P to distribute the Property to its partners, which would hold the Property as tenants in common and would have the rights and obligations of P under the contract.

On the day before the scheduled closing, P distributed undivided interests in the Property to its partners as tenants in common.

In connection with the distribution, P and its partners entered into an assumption agreement with P's lender. Under that agreement the partners assumed P's debt to the lender and agreed, among other things, not to partition the Property and not to transfer it to any third party

otherwise than in connection with repayment of the debt. The partners also undertook to reconvey their interests in the Property to P if the debt was not repaid by the last day to which the date of closing under the contract might be extended by the Authority.

The Property was sold to the Authority on the day after the distribution by P. L elected, in its tax return for the year of the sale, to defer the gain with respect to the disposition of its undivided interest in the Property under Code section 1033.

A requirement inherent in section 1033, as well as in section 1031, is that, in general, the taxpayer transferring property must also be the person acquiring the replacement property. Thus, if *the partnership* in TAM 9645005 had sold the Property and distributed the proceeds, *neither partner* would be able to avoid the recognition of gain by acquiring replacement property.

P's distribution of the Property was in all likelihood intended to permit L to avoid recognizing its gain from the sale by acquiring replacement property, while the other partner would either receive and retain its share of the condemnation proceeds or, possibly, reinvest in different replacement property. According to the TAM, however, the distribution failed to achieve the desired result for L.

### **TAM Conclusion**

The TAM concludes that, in substance, the Property was sold by P and not by its partners, relying on *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945), and other cases recharacterizing a distribution of property by a corporation to its shareholders, followed by a sale of the property negotiated by the corporation, as a sale by the corporation.

In support of the application of step transaction principles as developed by *Court Holding* and its progeny to the disposition of the Property, the TAM observes that the contract was entered into by P before the distribution, and was negotiated by the partners in their capacity as partners of P (rather than as prospective tenants-in-common); that the partners acquired undivided interests in the

Property subject to the contract obligation to convey the Property to the Authority; that the partners did not acquire the property until the day before the scheduled closing under the contract, and after the Authority gave indications that it intended to close the transaction as scheduled; and that the partners agreed to reconvey the Property to P if the sale failed to close within the period specified in the contract.

The TAM also concludes, seemingly gratuitously (in light of the first conclusion), that, "even if [L] had sold its tenants-in-common interest in the . . . Property," the sale would not have satisfied the requirements of section 1033 that apply where the replacement property is of like kind but not otherwise similar or related in service or use, because the circumstances indicated that L did not hold that interest for productive use in its trade or business or for investment. Specifically, the TAM asserts that (at least in this case) the receipt of the property subject to a requirement that it be sold pursuant to the terms of a contract assumed by the recipient was inconsistent with an "investment" holding purpose.

The ruling also observes that "there is no indication that the tenants-in-common interest generated income during the period it was held by" L. This is not inconsistent with an investment purpose, however: assuming that the land originally acquired by P had remained undeveloped and did not produce any income, the failure of L to share in nonexistent income would not, in itself, preclude a finding of "investment" purpose for its acquisition from P and continued ownership of the Property.

### **9th Circuit Decision**

In concluding that L could not have held its interest in the Property for purposes of investment, the TAM is less than entirely convincing in distinguishing *Bolker v. Commissioner*, 760 F.2d 1039 (9th Cir. 1985), in which the Ninth Circuit affirmed a Tax Court decision to the effect that property received by the sole shareholder of a corporation as a liquidating distribution, and later transferred by him pursuant to an exchange

agreement entered into on the date of distribution, was held "for productive use in trade or business or for investment" within the meaning of section 1031.

The Court of Appeals opinion states: "[I]f a taxpayer owns property which he does not intend to liquidate or to use for personal pursuits, he is 'holding' that property 'for productive use in trade or business or for investment' . . . . Under this formulation, the intent to exchange property for like-kind property satisfies the holding requirement, because it is not an intent to liquidate the investment or to use it for personal pursuits."

The TAM attempts to distinguish *Bolker* on the bases that (i) Mr. Bolker, rather than his corporation, entered into the exchange contract, such that the property was not acquired by him subject to a contract of sale; and (ii) that Bolker held the property for three months before its transfer pursuant to the exchange agreement.

It is not clear why either of these circumstances as cited in the TAM, while possibly relevant on the *Court Holding* issue, matter for purposes of applying the business or investment holding requirement as interpreted in *Bolker*. In particular, the emphasis on whether the entity or its investors negotiated the contract seems artificial in a context where a contract was negotiated by both of the members of a partnership and contemplated the completion of performance by either the partnership or its members.

In addition, the statement in the TAM that, at the time the plan of liquidation was adopted, Mr. Bolker had not contemplated the disposition of the property seems unfounded. The Tax Court opinion states that the plan of liquidation, although under consideration for some time, was not adopted by the corporation until a date five days before the distribution of the property, at a time when the purchaser had already agreed with Mr. Bolker on the sale terms. The TAM also fails to consider the possibility that a partner receiving property as a distribution from a partnership should be considered to hold that property with the same purpose as the partnership that had

previously been holding it, absent evidence to the contrary. *See also Mason v. Commissioner*, 55 TCM 1134 (1988).

In any event, the conclusion of the TAM that section 1033 did not apply seems unobjectionable, if only because the IRS was apparently on firm ground in concluding that the sale at issue should be viewed as having been made in substance by P, rather than by its partners, while the proceeds were clearly not reinvested by P. Although it is certainly arguable that the sale by the partners should have been respected, the contrary conclusion by the IRS is not surprising, in view of the short (1-day) actual holding period by the partners and the proba-

bility that the sale would in fact close as scheduled.

More generally, the TAM confirms that the IRS is continuing to scrutinize pre-closing restructurings needed to qualify for treatment under Code sections 1031 and 1033. Care must therefore be taken to establish the best possible record in support of the conclusion that the persons who, in form, are the transferors of the property also had the benefits and burdens of ownership and held the property with the requisite business or investment purpose prior to its disposition.

Consideration should also be given in similar circumstances to settling for

half a loaf by eschewing any pre-sale or pre-exchange restructuring, and instead, in a section 1031 context, causing the entity to (i) receive exchange property and cash "boot" and (ii) distribute the property so received and the cash on a disproportionate basis to the partners. Such an approach may permit an investor desiring to acquire replacement property to avoid recognition of the major portion of its share of the gain associated with the disposition, while mitigating or eliminating the tax risks associated with a pre-exchange distribution.

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