February 27, 2002

Exchange Interrupted

—*Qualifying for Tax Breaks for 'Like-Kind' Swaps*

By: Ronald A. Morris and Ezra Dyckman

Internal Revenue Code section 1031 provides that gain or loss is not generally recognized with respect to the disposition of property to the extent that such property is exchanged for like-kind property. Implicit in the term "exchange" is a requirement that the same taxpayer who disposed of property receive like-kind property. Section 1031, however, permits a "deferred exchange," where up to 180-days may elapse between the transfer of the relinquished property and the acquisition of the replacement property. What happens if a taxpayer dies during this 180-day period?

There is little authority on this question in the section 1031 area, but guidance is available in an analogous area. Under section 1033 of the Code, if property is involuntarily converted into cash, such as by the receipt of casualty insurance proceeds, and the taxpayer replaces the converted property by purchasing other qualified property within the period prescribed by the statute, the taxpayer can elect to defer the gain realized in the transaction.

In , 199 F.2d 895 (3rd Cir. 1952), the court held that a taxpayer's rights to defer gain recognition upon a casualty or condemnation are not necessarily lost by reason of his death. The court held that the personal representative of the deceased taxpayer could avoid recognition of gain by reinvesting the proceeds received from condemnation of property by the taxpayer during his lifetime, provided that the reinvestment was made within the period of time required by the statute.

The Internal Revenue Service originally followed this case in Revenue Ruling 58-407, 1958-2 C.B. 404; however, in Revenue Ruling 64-161, 1964-1 C.B. 298, the Service revoked Revenue Ruling 58-407, and held that a reinvestment of condemnation proceeds after the taxpayer's death by his representative did not qualify for section 1033 treatment, because the taxpayer who owned the converted property must be the one to reinvest the proceeds.

'Morris' and 'Gregg'

Despite the Internal Revenue Service's change of heart, the courts have continued to side with taxpayers on this issue. In , 55 T.C. 636 (1971), a husband and wife owned interests as tenants in common in a property which was condemned. The husband and wife planned to use the condemnation proceeds to build a replacement facility. Shortly after they received the proceeds, however, the husband died. The testamentary trustees and the widow used the proceeds to construct a replacement facility in accordance with the decedent's plans. The Tax Court followed the decision and held for the taxpayer. The court reasoned that the testamentary trustee was acting on behalf of the taxpayer and, therefore, complied with the statute:

Here, the decedent was the architect of the plan of replacement and had, prior to his death, set in motion the actions to implement that plan. He was precluded from completing those actions by the untimely event of death. Thereafter, his successors in interest, proceeding in strict accordance with the decedent's plan, finished the job. Under these circumstances, although the issue is not free from doubt, we think that it can be said that, for the purpose of perfecting the right of election conferred upon the decedent by section 1033(a)(3), the testamentary trustees were acting on his behalf in making the replacement.

The Court of Appeals for the Fourth Circuit affirmed this decision, but the IRS issued a "nonacquiescence." The Tax Court followed in , 69 T.C. 468 (1977), where the court again emphasized that the decedent's representatives were merely implementing the decedent's plans on his behalf.

Would the courts hold similarly in the section 1031 area? The section 1031 analog to the fact pattern is a case where the taxpayer transfers a property as the first leg of a like-kind exchange and then dies. In such a case, the transaction required by the statute has already commenced pre-death. This scenario presents a stronger case than a situation where the transaction required by the statute (, the reinvestment) occurs entirely post-death. While there is hope that the courts would extend and to their section 1031 analog, the Service's position remains unclear.[1]

A related issue arises where a corporation begins a like-kind exchange but undergoes a merger before the exchange is completed. The Internal Revenue Service has ruled privately that such an exchange may be completed by the successor entity. The most recent of these rulings is Private Letter Ruling 200151017. In this ruling, the IRS discusses section 381, which provides that when a corporation acquires the assets of another corporation as a result of certain reorganizations and liquidations, the acquiring corporation succeeds to certain tax attributes of the transferor corporation. The ruling explains that although section 1031 attributes are not mentioned in section 381 among the list of tax attributes which carry over, the section 381 list is nonexclusive. The ruling does say whether the existence of section 381 is necessary in qualifying a section 1031 transaction intersected by a corporate merger, but it does treat section 381 as establishing a precedent for carrying over tax attributes. Although not featured in the ruling's analysis, the ruling's holding with regard to a statutory merger of one corporation into another is supported by local law which usually treats the surviving corporation in a statutory merger as a continuation of the entity that was merged out of existence. In this respect, a liquidation of a subsidiary corporation into its corporate parent during an exchange is different; nevertheless, the IRS has issued favorable rulings in this situation as well.

The issue also comes up in the case of a trust which liquidates in the midst of a section 1031 exchange. This was the situation dealt with in Revenue Ruling 58-407 referred to above. Revenue Ruling 58-407 held that where property owned by a trustee is condemned and shortly thereafter the trust terminates, distributing the trust property to the beneficiary, the portion of the trust attributable to the condemnation proceeds may qualify for section 1033 treatment. Revenue Ruling 58-407 reasoned that a trust operates on behalf of its beneficiary and, therefore, it was the beneficiary's section 1033 transaction from beginning to end. This situation can be distinguished from a corporate liquidation, since in this context there is no analog to section 381 establishing a general succession by the beneficiary to the tax attributes of the trust. In any case, Revenue Ruling 58-407 was revoked by the Service in 1964.

Similarly, if a partnership begins an exchange and liquidates before completing it, the only argument in favor of section 1031 qualification is to "look through" the partnership from beginning to end.

Partnership Changes

What if a partnership merges or divides after beginning an exchange? Mergers and divisions of partnerships are governed by section 708 of the Internal Revenue Code. Regulations under section 708 provide rules for when a partnership will be considered a continuation of a pre-division or pre-merger partnership:

If two or more partnerships merge or consolidate into one partnership, the resulting partnership shall be considered a continuation of the merging or consolidating partnership the members of which own an interest of more than 50 percent in the capital and profits of the resulting partnership. If the resulting partnership can, under the preceding sentence, be considered a continuation of more than one of the merging or consolidating partnerships, , unless the Commissioner permits otherwise,   (net of liabilities) to the resulting partnership. Any other merging or consolidating partnerships shall be considered as terminated.

Thus, after a partnership merger, only one partnership can be a "continuation" for purposes of section 708. In contrast, these regulations provide as follows with regard to partnership divisions:

Upon the division of a partnership into two or more partnerships, ... or resulting partnerships….. Any other resulting partnership will not be considered a continuation of the prior partnership but will be considered a new partnership.

Thus, a partnership which divides may give rise to more than one continuation partnership.

Unlike section 381 in the corporate context, these regulations do not specify a list of tax attributes that carry over to a "continuation." Would the Service issue a ruling analogous to the rulings it has issued in the context of corporate mergers? Although the partnership regulations do not contain the laundry list of inherited tax attributes, arguably this is because a successor to a merged or divided partnership is considered by the statute to be a "continuation," which may mean for all purposes under the Code.

What if the only change to a partnership in mid-exchange is the sale of a partnership interest. It is hard to sympathize with a partnership trying to complete a like-kind exchange if 99% of the interests therein are no longer owned by the partners who were in place at the beginning of the exchange, but where do we draw the line? Section 708 provides that a partnership terminates only if "within a 12-month period there is a sale or exchange of 50 percent or more of the total interests in partnership capital and profits." Thus, it seems that if there is in the aggregate less than a 50% transfer, the partnership is treated as the same entity for all purposes.

Some question remains with respect to these various changes occurring to a partnership during a like-kind exchange, since section 708 states that its rules are for purposes of subchapter K (the portion of the Internal Revenue Code pertaining to partnerships) and since the Service sometimes likes to take the position that outside of subchapter K a partnership is treated as an aggregate of individuals (and/or entities) rather than a single entity.

Thus, last year's private letter ruling blessing a like-kind exchange interrupted by a statutory merger frustratingly brings to mind a half dozen other cases which remain shrouded in fog.

1 Private Letter Ruling 9829025 which deals with income in respect of a decedent and community property, suggests that an exchange begun by a taxpayer can be completed after his death by the decedent's representative in a way that qualifies under section 1031.