April 23, 2004

Understanding Partition of a Tenancy-in-Common

By: Ronald A. Morris and Ezra Dyckman

Determining the tax results of a transaction requires a clear understanding of the transaction. In complex, multi-step transactions, clients and even lawyers, all focusing on where they want to get, often misconstrue the legal steps that take them there.

This problem is not, however, limited to complicated situations. A recent private letter ruling issued by the Internal Revenue Service turns on the characterization of an extremely simple transaction: a partition of a tenancy-in-common. Private Letter Ruling 200303023 deals with the following facts:

A contiguous tract of real estate is owned as tenants-in-common by A, B, C, and T. A and B are parents of C, and T is a trust for the benefit of D, another child of A and B. A and B, as joint tenants, own an undivided fee interest in three-sixths of the tract and a life estate for the life of the survivor of A and B in one-sixth of the tract. C owns an undivided fee interest in two-sixths of the tract. T owns a remainder interest in the one-sixth interest in which A and B own a life estate.

The tract is partitioned into separately owned parcels of property, as follows: (i) A and B own a parcel as joint tenants in fee simple; (ii) A and B also own a life estate for the life of the survivor in a parcel; (iii) T owns the remainder interest in the parcel in which A and B own a life estate; and (iv) C owns two parcels in fee simple.

The ruling contains the following additional factual information: (i) Based on appraisals obtained, each taxpayer's share of post-partition property is approximately equal in value to the value of that taxpayer's undivided interest in the tract immediately prior to the partition; and (ii) None of the taxpayers are disproportionately benefited as a result of the partition, and no gift is made or received as a result of the partition.

Sale or Exchange?

The issue in the ruling is whether, for income tax purposes, the partition is a sale or exchange. Simplifying the facts will allow us to get to the heart of the matter.

If A and B are each 50 percent tenants-in-common with respect to a tract of unimproved land, and they partition the land, each receiving one-half, what are the tax consequences? To answer this question, we must first understand the nature of a partition under general legal principles.

Each tenant-in-common starts with an interest of 50 percent in the whole and ends up with 100 percent in one-half. How can the transaction be a "nothing" for tax purposes when each co-owner is clearly giving up something he had before? Does the partition represent an exchange by each tenant of a 50 percent interest in the half he is relinquishing for a 50 percent interest in the half he is acquiring?

Alternatively, did each party always own an undefined half of the parcel and does the partition merely give definition to that ownership? If the latter is true, the partition is merely changing the legal form of ownership while leaving the beneficial ownership unchanged.

The ruling discusses the following authority:

Section 1001 of the IRS Code provides that gain or loss is realized upon the sale or other disposition of property. The tax law distinguishes between "realizing" gain or loss, which means that an economic profit or loss has resulted, and "recognizing" gain or loss, which means that the item is taken into account in computing taxable income. For example, when a property is disposed of in a like-kind exchange, qualifying under section 1031 of the Code, gain is realized but not recognized (except to the extent of nonqualifying property received).

Section 1.1001-1(a) of the Treasury Regulations provides that generally "the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained" (that is, is realized for tax purposes).

The letter ruling then applies these principles as follows:

> For purposes of section 1001, in an exchange of property, each party to the exchange gives up a property interest in return for a new or additional property interest. Such an exchange of property is a disposition under section 1001(a). (See section 1.1001-1.)
>
> In a partition, the parties do not acquire a new or additional interest. (See *Noble v. Beach*, 130 P.2d 426, 430 [Cal. 1942].) The partition of jointly-owned property is not a sale or other disposition, but merely the severance of joint ownership.

An exchange of property is clearly a realization event, but does a partition give rise to an exchange? Citing a California real estate case the IRS concludes that in a partition the parties "do not acquire a new or additional interest."

Revenue Rulings

The letter ruling goes on to discuss two Revenue Rulings. Revenue Ruling 56-437, 1956-2 C.B. 507, holds that the partition of a joint tenancy in corporate stock and the issuance of two separate stock certificates in the names of each joint tenant, is a nontaxable transaction for federal income tax purposes. There is no sale or exchange, and the taxpayers neither realize a taxable gain nor sustain a deductible loss.

Revenue Ruling 73-476, 1973-2 C.B. 301, holds that if three tenants-in-common holding three separate parcels rearrange their interests so that each party becomes the sole owner of one of the parcels, an exchange occurs so that gain or loss is realized. This ruling goes on to say that section 1031 of the Code (governing like-kind exchanges) applies such that no tax is generated with respect to the transaction.

Note, however, that although section 1031 will often apply to partitions of real estate to eliminate gain recognition, there are cases where the section's requirements are not met (for example, where tenants-in-common own real property used as a personal residence or where section 1031(f) might disqualify the exchange because one of the related parties plans to sell his partitioned share within two years). Apparently, section 1031 did not apply to the taxpayers in Private Letter Ruling 200303023 for some reason.

Private Letter Ruling 200303023 concludes under its facts that because the tract is contiguous and no exchange of separate parcels of property occurs, the result in Revenue Ruling 56-437, rather than that of Revenue Ruling 73-476, applies. Therefore, the partition of the tract is not treated as a sale or exchange by the taxpayers

Private Letter Ruling 200303023 distinguishes Revenue Ruling 73-476 because the revenue ruling deals with tenancies-in-common in different parcels of land while the private letter ruling deals with one contiguous parcel. Where tenants-in-common share two parcels, there are really two separate tenancies-in-common. In fact, it would be possible to have a third tenant-in-common participate in one property but not the other. In the two-parcel case, therefore, since each tenant clearly owns an interest in each property prior to partition, the only coherent interpretation of the transaction is that each tenant-in-common exchanged an interest in one property for an interest in the other.

The letter ruling's facts, however, also differ from Revenue Ruling 56-437, which deals with a joint tenancy in corporate stock. Since two shares of the same class of stock of the same corporation are identical for all practical purposes, a 50 percent undivided interest in two shares of stock is economically indistinguishable from a 100 percent ownership interest in a single share of stock and, therefore, the partition of such a tenancy is merely a change of legal form, the issuance of two stock certificates in place of one. However, in the case of land, after the dust clears, one tenant is the sole owner of the northern portion and the other the sole owner of the southern portion. Since there is no such thing as identical real estate, clearly something more than a change of legal form has occurred. Nevertheless, the ruling follows the result of Revenue Ruling 56-437.

Unclear Rationale

The rationale of the ruling is not entirely clear. However, it seems to rely on the theory that the partition is a mere change of legal form, merely defining the undefined interest.

Alternatively, perhaps the IRS would admit that an economic shift has occurred, but (based on the regulation cited above) maintains that the change (within a single contiguous parcel) is not material "either in kind or in extent."

How does this issue play out in the case of the New York State Real Estate Transfer Tax and the New York City Real Property Transfer Tax? Section 1405 of the New York Tax Law provides:

> (a) The tax shall not apply to the following conveyances: ... Conveyances which consist of a deed of partition.

Section 2303(j) of the New York City Real Property Transfer Tax Rules provides:

> Conveyances Not Subject to Tax. The following are examples of situations in which the tax does not apply: ... Partition deeds, unless, for a consideration, some of the parties take shares greater in value than their undivided interests, in which event the tax attaches to each deed conveying such greater share, computed upon the consideration for the excess.

Applying these rules to our simplified case, where each tenant-in-common starts with a 50 percent interest in the entire tract and ends up with a 100 percent interest in half of the tract, going from fifty-percent to zero in the other half. In such a case, the familiar transfer tax exemption that applies to the extent that beneficial ownership of the realty stays the same, may not provide a full exemption, since each tenant has disposed of a 50 percent beneficial interest in half of the parcel. Yet, based on the New York statute and the New York City regulations cited above, a partition transaction (which does not result in a shift of value) is not subject to transfer tax at all.

Thus, we have seen the importance and difficulty of understanding even "simple" real estate transactions and, for a change, the federal income tax and the New York transfer taxes are in sync on a complex issue, both looking at a partition of a tenancy-in-common simply as a change in legal form rather than an exchange of property.