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construed as prospective only. If this is correct, the effectiveness of the Act as to the number of surface owners it may protect is greatly reduced.

The Act does not prohibit independent contracting as to surface damages. This was true under the common law as well. It has been recognized as a matter of judicial notice that most modern leases contain surface damage clauses. It has been common practice for operators to compensate surface owners for surface use. This practice in all probability will continue despite the existence of the Act. While this practice suggests that the Act was unnecessary to protect surface owners, it also suggests that the Act will actually serve to protect only a small number of surface owners. In this sense the Act serves merely to complicate the contractual arrangements of the parties by requiring such things as bond and notice of intent to drill.

In those rare instances in which the Act will actually serve to protect a surface owner, the ambiguities within it will complicate rather than simplify the relationship of the parties. In view of these ambiguities and the severity of treble damages for mistakes, the oil and gas operator is in a precarious situation in conducting his drilling operations. As a major oil- and gas-producing state, Oklahoma should reconsider the desirability of this Act.

L. Mark Walker

Author's Note: Prior to publication, Judge Thomas R. Brett ruled that the Act may not be constitutionally applied to leases executed prior to the effective date of the Act. [Hughes Group v. Morgan, Docket No. 82-C-995-BT, U.S.D.C. (N. D. Okla. 1983)] Although the decision will not be reported and therefore will not create a precedent, it may be indicative of the court's response to the Act and will be persuasive authority in future cases.

Taxation: Like-Kind Exchanges of Partnership Interests: Availability of § 1031 and Effect of Nonqualifying Property*

The Internal Revenue Code of 1954 (hereafter Code), section 1031(a) provides an exception to the general rule requiring recognition of gain or loss upon the sale or exchange of property. Under this section, no gain or loss

89. See Marland Oil Co. v. Hubbard, 168 Okla. 518, 519, 34 P.2d 278, 279 (1934).

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1. I.R.C. § 1031(a).
2. See Code § 1001 and the regulations thereunder for the general rules requiring recognition of gain upon sale or exchange of property.
is recognized if property held for productive use in a trade or business or for investment is exchanged solely for property of a like-kind to be held either for productive use in a trade or business or for investment. This provision has the effect of deferring the income tax impact of a realized gain or loss until disposition of the acquired property.\(^3\)

In recent years, taxpayers have asserted the applicability of this section to the exchange of partnership interests. The basis for this assertion is that partnership interests are "properties" being exchanged and that such "properties" are held for investment. Taxpayers further contend that the partnership interests involved are of a "like-kind," making the nonrecognition of gain or loss provisions applicable. This results in the exchange being either tax-free or only partially taxable. Predictably, the Internal Revenue Service rejects these arguments and has consistently denied section 1031 deferral treatment in exchanges of partnership interests.\(^4\) Upon litigation, however, the Tax Court has been much more receptive to the taxpayer's position and has held that, in certain circumstances, an exchange of partnership interests will qualify for section 1031 treatment.\(^5\)

Because of the conflicting positions taken by the Tax Court and the Commissioner, it is important to understand the considerations involved when traditional problems inherent in partnership taxation\(^6\) intersect with the specific nonrecognition of gain or loss requirements of section 1031. The purpose of this note is to discuss the prevalent tax considerations existing when a partner in one partnership wishes to exchange his interest for an interest in another partnership pursuant to section 1031.

**Availability of Section 1031**

The first issue that must be addressed is whether partnership interests can even be considered for section 1031 nonrecognition treatment. This question

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3. The deferral effect is accomplished by § 1031(d), which provides that the basis in acquired property shall be the basis of the property exchanged decreased by the amount of any money received by the taxpayer and increased in the amount of gain or decreased by the amount of loss recognized on the exchange. If the taxpayer were to sell the acquired asset immediately, gain would then be recognized to the full extent of the difference between the taxpayer's basis and the amount realized. This again represents the amount not recognized under § 1031, thereby providing a deferral until the disposition of the acquired property.


6. Many problems arising in partnership taxation result from indecision about whether to treat the partnership as a separate entity or simply as an aggregation of the individual partners. For a general discussion of both approaches, see 1 W. McKee, W. Nelson & R. Whitmire, Federal Taxation of Partnerships and Partners, ¶ 1.02 (1977); 1 A. Willis, J. Pennell, P. Postlewaite, Partnership Taxation §§ 2.04-2.09 (3d ed. 1982).
arises because of the parenthetical language in section 1031 providing that certain property is excluded from nonrecognition treatment. Excluded property includes "stock in trade or other property held primarily for sale, . . . stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest." The Commissioner contends that a partnership interest is specifically excluded by this language. Revenue Ruling 78-1354 posited that this language encompasses all types of equity interests in financial enterprises other than direct ownership of the underlying property. The ruling concluded that because a partnership interest represents such an equity interest, it comes within the ambit of the exclusory clause. In every case thus far presented to the Tax Court, the Commissioner has argued that a partnership interest should be characterized either as a "chose in action" or an "evidence of . . . interest." On each occasion, the Tax Court has rejected such arguments because they would limit the scope of section 1031 by excluding partnership interests. Upon judicial review of the legislative history of the statute, the Tax Court held that partnership interests were simply not property that Congress intended the parenthetical language to exclude. In the recent case of Pappas v. Commissioner, this reasoning led the Tax Court summarily to dismiss this facet of the Commissioner's argument by citing precedent indicating that the government's position will be rejected when applied to the exchange of general partnership interests. Such cursory treatment indicates that the Tax Court is attempting to put this contention permanently to rest.

In Pappas the court also addressed another issue raised by the Commissioner that would preclude application of section 1031. In that case, the taxpayer was involved in two exchanges of general partnership interests. In each

7. I.R.C. § 1031(a).
8. 1978-1 C.B. 256.
9. Id. at 257.
12. For a detailed discussion, see Banoff & Fried, An Analysis of Recent I.R.S. Attempts to Narrow the Scope of the Tax-Free Like-Kind Exchange, 51 J. TAX 66 (1979).
13. It should be noted that the court's discussion regarding the initial qualification of a partnership interest has been limited to general partnership interests. As discussed later, limited partnership interests could possibly be characterized so as to fall within the exclusion. See infra text accompanying notes 35-41.

The court determined that the purpose of the parenthetical language is to prevent taxpayers who own appreciated investment securities from exchanging them for other investment securities without recognizing gain. Otherwise, taxpayers would be allowed to defer gain recognition on appreciated securities by exchanging them, while currently recognizing losses on sales of depreciated securities. See Meyer v. Commissioner, 58 T.C. 311, 313 (1972).

The court's conclusion is supported by the legislative history of the Revenue Act of Mar. 4, 1923, which introduced the earliest predecessor of the parenthetical exclusion language. See H.R. REP. No. 1432, 67th Cong., 4th Sess. 1 (1923); 64 CONG. REC. 2852-54 (1923) (remarks of Representatives Green, Garner, and Fordney).
transaction, he acquired a 50% interest in the target partnership, thereby resulting in his becoming the sole owner of the partnership.\textsuperscript{16} In addition to the parenthetical exclusion issue, the government asserted that section 741\textsuperscript{17} requires that gain or loss be recognized when partnership interests are exchanged, notwithstanding section 1031, because section 741 and section 1031 are conflicting provisions\textsuperscript{18} and section 741 overrides section 1031 because of its greater specificity.\textsuperscript{19} The court squarely addressed this issue for the first time\textsuperscript{20} and concluded that these sections are not conflicting. The court held that section 1031 is a nonrecognition provision while section 741 is a characterization provision. Therefore, the characterization provision only becomes operative when gain recognition occurs in order to determine the character of such gain. If there is no gain under the nonrecognition provisions of section 1031, section 741 remains dormant.\textsuperscript{21} The court reasoned that the legislative history of section 741 emphasizes characterization and not recognition,\textsuperscript{22} that the regulations do not support the Commissioner’s argument,\textsuperscript{23} and that precedent supports this approach.\textsuperscript{24}

In Revenue Ruling 78-135, two arguments were advanced to preclude the application of section 1031. As mentioned above, the first argument was predicated upon the parenthetical property exclusion in section 1031(a) and the second was the section 741 argument. Considering the Tax Court’s consistent position that a general partnership interest is not automatically excluded by the parenthetical clause of section 1031(a), and viewing the court’s specific rejection of the section 741 argument in \textit{Pappas}, one must wonder whether the ruling reflects the Commissioner’s current position.\textsuperscript{25}

\textsuperscript{16} The underlying assets involved in the exchange will be addressed later. See infra text accompanying notes 46-49. The focus of this discussion is first to determine whether an exchange of partnership interests may be considered for § 1031 treatment. If so, issues relating to the operative language of this section come into play and the underlying assets become a factor.\textsuperscript{17} I.R.C. § 741. This section provides that gain or loss recognized on the sale or exchange of a partnership interest shall be treated as gain or loss from the sale or exchange of a capital asset.\textsuperscript{18} Pappas v. Commissioner, 78 T.C. 1078, 1086 (1982).\textsuperscript{19} For other examples of application of this rule of construction, see Ginsberg & Sons v. Popkin, 285 U.S. 204 (1932); Essenfeld v. Commissioner, 37 T.C. 117, 123 (1961), aff’d 311 F.2d 208 (2d Cir. 1962).\textsuperscript{20} Although \textit{Pappas} was the first case that confronted the § 741 issue, it was by no means the first time the issue was raised by the Commissioner. In fact, this contention was raised in every prior case involving partnership exchanges, but only impliedly overruled. See Pappas v. Commissioner, 78 T.C. 1078, 1087 (1982).\textsuperscript{21} Id. at 1086-87.\textsuperscript{22} H.R. REP. 1337, 83d Cong., 2d sess. A232 (1954). See also S. REP. 1622, 83d Cong., 2d sess. 376 (1954).\textsuperscript{23} Pappas v. Commissioner, 78 T.C. 1078, 1087 (1982).\textsuperscript{24} Id.\textsuperscript{25} 1978-1 C.B. 256. The advance sheets containing the \textit{Pappas} opinion indicated that the Commissioner conceded at trial that the taxpayer’s first exchange of one general partnership interest for another with identical underlying assets was nontaxable. In the official opinion, however, the concession is reversed and the taxpayer concedes that the first exchange was taxable, thereby resulting in a short-term capital loss of $497.59. Pappas v. Commissioner, 78 T.C. 1078, 1088 (1982).
pears firmly established that an exchange of partnership interests may be initially considered under section 1031 to determine if it qualifies for nonrecognition treatment. However, taxpayers should be cognizant of the Internal Revenue Service’s persistence in this area when attempting to apply section 1031 to such an exchange.

**Tier One Analysis**

Although it appears that an exchange of partnership interests is not automatically excluded from section 1031, the exchange must qualify under the operative language of section 1031(a) before nonrecognition treatment is available. The determination as to whether a particular exchange qualifies is made especially difficult because of the idiosyncrasies of partnership entities. For example, should the requirements of section 1031(a) be applied to the partnership interests, the underlying assets of the partnership, or both?

In each Tax Court case involving these issues, that forum has either expressly or implicitly applied a two-tier analysis to determine whether an exchange qualifies under section 1031. The first tier is applied to the partnership interests. In order for nonrecognition treatment to apply, the tests at both tiers must be satisfied. Tier-two analysis is applied to the underlying partnership assets and involves many questions that, until recently, have remained unaddressed by the court.

The court first examines the partnership interests exchanged in order to ascertain if they are of a like-kind. The reasoning used by the court is that section 1031(a) applies only to the "property" being exchanged. The court has treated the partnership interests, and not the underlying partnership assets, as the "property" exchanged. In adopting this approach, the court is using an entity theory of partnerships in analyzing the problem. Accordingly, the court has held that the "determination of whether the exchange initially qualifies as like-kind... will be applied to the partnership interests and not on a partnership-asset-by-partnership-asset approach." It thus appears that the court could base its determination upon whether the exchanged interests are general for limited, limited for limited, or general for general.

In *Estate of Meyer v. Commissioner*, the first Tax Court case to present  

26. The first court to be presented with this issue was a district court. In Miller v. United States, 63-2 U.S. Tax Cases (CCH) ¶ 9606 (S.D. Ind. 1963), the court held that an exchange of interests in general partnerships conducting different types of retail business was an exchange of like-kind property and no gain should be recognized. Both partnerships owned inventory and notes which, if exchanged directly, would have been ineligible for § 1031 treatment.

It should be noted that this is an unreported decision, and the court reached its holding without citing any relevant authority or providing detailed analysis. Accordingly, the precedential value of this case is doubtful.

27. The court has so far presumed that the partnership interests exchanged were held for investment purposes.


30. 58 T.C. 311 (1972), *aff'd per curiam*, 503 F.2d 556 (9th Cir. 1974). The Commissioner has not acquiesced to this holding. *See* 1975-1 C.B. 3.
the issue of tax-free exchanges of partnership interests, a father and his son each exchanged general partnership interests in a general partnership for interests in a limited partnership. The father received a limited partner interest and his son received a general partner interest. Prior to and after the exchange, both partnerships were principally engaged in the ownership and operation of rental apartments. The court held that although the son’s exchange qualified for nonrecognition under section 1031(a), the father’s exchange of a general partnership interest for a limited partnership interest was not an exchange “of property of like-kind.”

The court reasoned that:

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\text{The differences in the characteristics of the interest of a general partner and that of a limited partner are considerable. . . . [T]hat a limited partner, unlike a general partner, is not personally liable for partnership debts and that he is entitled to priority in liquidation are the law in [this jurisdiction]. [Citations omitted.] Also, absent agreement to the contrary the death of a limited partner does not work a dissolution of the limited partnership.}
\]

\[M\text{eyer}\] has been cited for this proposition by the court in every subsequent case presenting the issue of “partnership-swapping” under section 1031. In \[P\text{appas}\] the court stated that “it is well established that . . . an exchange . . . of a general partnership interest for a limited partnership interest is not an exchange of property of like-kind.” Such statements are indicative of the tax consequences resulting when the interests exchanged are characterized as general for limited.

Although no case has directly posed the problem, an exchange of a limited partnership interest for another limited partnership interest could possibly fall within the parenthetical exclusion of section 1031(a) because limited partnership interests have several characteristics normally associated with securities, and securities are specifically denied like-kind treatment. Such characteristics

31. 58 T.C. at 314. As discussed \textit{infra}, beginning with the text accompanying note 46, \textit{infra}, the majority indicated that the crucial factor in determining whether § 1031 should apply is the second-tier analysis relating to the underlying assets of the partnership. Judge Dawson vigorously dissented, arguing that the underlying assets of the partnerships involved were virtually the same (rental real estate). \textit{Id.} at 315. He concluded that because the underlying property was the same, the distinction made by the majority was merely one of quality, grade, or value. Such distinctions do not prevent property being like-kind, according to the regulations at § 1.1031(a)-(1)(b). See Banoff & Fried, \textit{supra} note 12, at 71.


34. 78 T.C. 1078, 1084 (1982).

35. In discussing the various characteristics of a security for § 1031 purposes, it is assumed that the court will use the criteria associated with federal securities law and not those employed for federal income tax purposes. (i.e., not 1.R.C. § 1236(c)). See Banoff & Fried, \textit{supra} note 12, at 69.

36. This attack could also be used in an exchange of a general partnership interest for a limited one, as was the case in \textit{Meyer}. However, the court decided that case without having to address the issue of whether the limited interest constituted a security for § 1031 purposes.
include the limited partner's inability to actively participate in the partnership's business and his limited degree of liability. As the Court of Appeals for the Ninth Circuit pointed out in affirming the Tax Court's decision in Meyer, an individual with a limited partnership interest might reasonably be regarded as "an investor, dependent upon the efforts of others to make a profit." The effect of this statement is clear when viewed in the context of federal securities law, which generally provides that if an investor has no control over the management of the enterprise and looks to the efforts of others for profit, he is considered to hold a security. Moreover, the Securities and Exchange Commission has stated that a limited partnership interest in a real estate venture will generally constitute a security under the Securities Act of 1933. Accordingly, potential characterization of the limited partner's interest as a security must be considered when limited partnership interests are involved in a like-kind exchange.

The final possibility is an exchange of a general partnership interest for another general partnership interest. As mentioned, this type of exchange repeatedly has been approved by the Tax Court. Nonetheless, a partnership interest nominally general could possibly be recharacterized by the Commissioner as a limited partnership interest. Under Meyer, such an exchange would not qualify as like-kind, rendering section 1031 inapplicable. The most likely basis for recharacterization of a general partnership interest is when it, in substance, has many of the intrinsic traits of a limited partnership interest.

37. Meyer v. Commissioner, 58 T.C. 311, 558 (1972), aff'd 503 F.2d 556, 558 (9th Cir. 1974).
38. See supra note 35.
39. See SEC v. Howey Co., 328 U.S. 293 (1946), which sets out four specific criteria for determining if a particular interest is a security.
41. Various methods of countering the "security attack" to the limited partnership interest have been made. One involves structuring the partnership agreement so that the limited partner has the right to become a general partner and assume an active role in management if the partnership's business deteriorates beyond a specified point. It would be logical to assert that the existence of this right makes the limited partner more than a mere investor. See Chromow, Tax-Free Exchanges of Partnership Interests: Gulfstream Land and Rev. Rul. 78-135 Impose Constraints, 57 TAXES 651, 657 (1979).

Another argument postulated is that the purpose of the parenthetical language in § 1031 is to exclude liquid investments that are readily convertible into cash. Because limited partnership interests are generally illiquid, they should not be treated as securities for section 1031 purposes. See Duhl, Like-Kind Exchanges Under Section 1031: Multiparty Exchanges, Nonsimultaneous Exchanges and Exchanges of Partnership Interests, 58 TAXES 949, 963 (1980).
42. This attempt was made in Long v. Commissioner and rejected under those facts. In Long, the Commissioner argued that the general interest traded was a limited interest because: the taxpayer was not personally liable on the mortgages of the partnership; the partnership agreement provided that the taxpayer-partners would not be required to make any further capital contributions; and the agreement further provided that the taxpayer was to recover his initial investment plus interest upon dissolution and liquidation of the partnership.

In rejecting this argument, the court found it dispositive that the partnership was not formed as a limited partnership under applicable state law. Long v. Commissioner, 77 T.C. 1045, 1065 (1981).
Another possible reason for recharacterization arises where the taxpayer engages in a number of general partnership exchanges, eventually owning an interest in a limited partnership directly or indirectly. Depending upon the circumstances, the Commissioner could assert one of several judicially created doctrines to view the exchange as a single transaction in which a limited partnership interest was acquired. Thus, the fact that general partnership interests are being exchanged should not lull one into a sense of security in dealing with first-tier analysis of partnership interests under section 1031.

**Tier Two Analysis**

Assuming that the partnership interests exchanged are of a "like-kind," and are not excluded from section 1031(a) by its parenthetical language, the second-tier analysis must be applied. This analysis scrutinizes the underlying assets of the partnership interests exchanged. The primary purpose of this scrutiny is to prevent abuse of section 1031 by taxpayers attempting to obtain nonrecognition treatment by contributing nonqualifying property to partnerships, then exchanging partnership interests. However, the scope and result of such "abuse" has not yet been addressed by either the Tax Court or the Internal Revenue Service. The uncertainties in this tier of the analysis result from two factors: (1) the consistent position of the Tax Court in allowing section 1031 to apply to an exchange of partnership interests, and (2) applying the requirements of section 1031 to a partnership despite its somewhat amorphous nature.

One of the uncertainties in the second-tier analysis involves the effect of property excluded by the parenthetical clause in section 1031(a) held by the partnership. Three possibilities exist, the first being that the presence of any such excluded assets would totally preclude application of section 1031. The

43. A potential argument as yet unused by the Commissioner may apply when a taxpayer exchanges so many partnership interests within a relatively short period that he can no longer be considered an investor. This would result in his being treated as a dealer in such interests with the interest consisting of "stock in trade" which is specifically excluded from § 1031 treatment. Like the "security attack," this would have the effect of precluding nonrecognition treatment in the first-tier analysis.

44. This argument was presented and rejected under the facts of Pappas v. Commissioner, 78 T.C. 1078, 1085 (1982).


47. Of course, as long as the official position of the Internal Revenue Service, as expressed in Rev. Rul. 78-135, 1978-1 C.B. 256, is to not recognize partnership interests as qualifying for § 1031 treatment, no Treasury Regulations will be forthcoming.

48. All uncertainty would have been eliminated if the court had originally agreed with the Commissioner that § 1031 is inapplicable to such exchanges. The unstated reason of the court for allowing its application appears to be that nonrecognition treatment should not be disallowed on an exchange that would otherwise qualify merely because of the partnership form.
second alternative is that such assets would not preclude application, but nonqualifying property would instead be isolated and treated as "boot" under section 1031(b). The final possibility is that existence of such property within the partnership would have no effect on the transaction, either as boot or by precluding nonrecognition treatment, unless the nonqualifying assets comprise a significant portion of the total underlying assets exchanged. Recent decisions indicate a strong preference for the last alternative.

In Gulfstream Land & Development Corp. v. Commissioner, an interest in one joint venture was exchanged for an interest in another. Both joint ventures had been formed to develop and improve land and to build homes thereon for sale. The Commissioner argued that the underlying assets consisted of "stock in trade," an excluded asset, as well as real estate. The court held that, in accordance with Meyer, it "will apply the judicial doctrine that the form of a transaction will not be given effect for tax purposes if the substance of the transaction would yield a contrary tax result." The court then found that whether the partnership's property constituted "stock in trade" was an unresolved issue of material fact compelling a denial of the taxpayer's motion for partial summary judgment. Gulfstream indicates that section 1031 is inapplicable to an exchange if a substantial amount of the underlying property consists of excluded assets. The inverse corollary of this proposition is that, if a substantial amount of the underlying assets is quali-

49. Code § 1031(b) provides that if nonlike-kind property is received in an exchange otherwise qualifying for nonrecognition treatment, any gain realized by the recipient shall be recognized to the extent of the sum of the money and the fair market value of the nonlike-kind property received.

For a discussion of the technical difficulties involved if a court were to isolate excluded assets and treat them as boot, see Chromow, supra note 41.


51. Code § 761(a) provides that a joint venture falls within the definition of a partnership for federal income tax purposes. See Long v. Commissioner, 77 T.C. 1045, 1064 (1981) (Commissioner's contention that an exchange of a partnership interest in return for a joint venture interest was not like-kind for purposes of § 1031(a) was rejected).


53. Although this was the first time the "substance over form" doctrine was articulated in this context, the court stated that it was inferred in the concluding paragraph of the Meyer opinion. That paragraph confined the court's decision (that an exchange of general partnership interests qualified as like-kind) to situations where both partnerships owned the same type of underlying assets. The court expressed no opinion as to the result if varying types of underlying assets were involved or if there were variations in the nature of the partnerships' businesses. Meyer v. Commissioner, 58 T.C. 311, 314 (1972).

In Gulfstream, the court asserted that its examination of the underlying assets in Meyer and its conclusion of fact that they were like-kind (rental real estate) was an application of this judicial doctrine.


55. The Gulfstream facts present an obvious example of the type of abuse the court sought to prohibit. All of the underlying assets in both joint ventures consisted of developed realty held for sale to customers.
fying property, section 1031 applies to the exchange. This is the third alternative presented to the court and appears to be the position taken by the court in Long v. Commissioner.

In Long the Tax Court's primary concern was the taxpayer's manipulation of partnership liabilities to prevent gain recognition by virtue of the liability-netting rules of section 1031(d). However, a portion of the underlying assets in both partnerships consisted of property excluded by the parenthetical phrase of section 1031(a). Although the court held that any gain realized must be recognized to the extent of net liabilities relieved, it did not segregate nonqualifying property and treat it as boot, nor did the existence of such assets preclude nonrecognition treatment. The rationale for this result appears to be that existence of a normal amount of cash in a partnership does not constitute abuse of section 1031(a). Accordingly, Long demonstrates that if the amount of excluded property in the underlying assets exchanged is insubstantial, nonrecognition treatment should still be available. The court, however, issued a caveat that "all contributions of property to a partnership and indebtedness incurred at or near the time of the exchange will be carefully scrutinized ... to insure that such activities are not undertaken for tax avoidance purposes." The court further stated that it would not hesitate to apply judicially created theories such as the "sham" and "step" transaction doctrines. The court's admonition is targeted, at least in part, to those taxpayers who would inflate liabilities or contribute cash to the partnership in an attempt to make the exchanges of equal value without the payment of boot.

Aside from uncertainties relating to the presence of parenthetical property in the underlying assets exchanged, another uncertainty exists in the second-tier analysis. This uncertainty involves the effect of nonlike-kind property in the underlying partnership assets exchanged. These are assets which, though not excluded by the parenthetical language, would not otherwise qualify as like-kind under section 1031(a) because similar property is not held by the other partnership. Although this problem is much like the issue relating to

56. Meyer provides support, albeit tenuous, for this proposition. The court allowed § 1031 treatment to the son's exchange, noting that "both partnerships had as their principal activities the ownership and operation of rental apartments. . . ." Meyer, 58 T.C. at 312 (emphasis added). Although the court mentions the "principal activities," it expresses neither the percentage amount nor the nature of other partnership operations involved.


58. I.R.C. § 1031(d). This provision provides for the netting of liabilities relieved against liabilities assumed in a section 1031 transaction. In the event that the amount of debt relieved exceeds debt assumed, such amount will be treated as money received and result in possible gain recognition.

59. According to the balance sheets of the entities, 77 T.C. at 1060-61, in Long, 80,953/2,008,791 of the underlying assets exchanged represented cash while 6,301/963,769 of the underlying assets received represented cash.

60. If considered nonabusive, the same rationale would seem to apply to other parenthetically excluded property (securities, stock in trade, etc.).

the presence of excluded property, some authorities assert that this issue should be addressed differently. However, the alternatives as to treatment of nonlike-kind assets are the same as those available when dealing with excluded property. Case law indicates that the existence of nonlike-kind property in the underlying assets will have no effect on the application of section 1031, as boot or otherwise, unless it represents a substantial portion of the exchanged assets.

In Pappas the taxpayer was involved in two exchanges of general partnership interests. In the first exchange, the underlying assets of the partnerships whose interests were exchanged were identical. However, the second exchange involved receipt of an interest in a partnership containing personal property and realty in exchange for an interest in a partnership that owned only realty. It was stipulated that, except for the personal property involved, all of the underlying assets in the second exchange were property of a “like-kind” within the meaning of section 1031(a). The Commissioner did not assert that section 1031 was inapplicable to the exchange, but instead contended that the boot provisions of section 1031(b) should be applied to the dissimilar assets.

The court held that the taxpayer need not recognize any gain realized from the exchange of these general partnership interests except for liabilities assumed taxable as boot. However, in doing so, it appears that the court disposed of the Commissioner’s contention by answering an unasked question. In its holding, the court stated that the personal property involved was clearly not stock in trade as may have existed in Gulfstream. Therefore, the court concluded that it could not be excluded from nonrecognition under section 1031(a) nor considered boot under section 1031(b). Although the court held that the personal property was not excluded by the parenthetical clause in section 1031(a), it did not specifically address the issue relating to treatment of nonlike-kind underlying assets. Nonetheless, Pappas provides precedent for the proposi-

62. The American Law Institute, in its income tax proposals relating to subchapter K, recommends such differing treatment. Under its proposals, parenthetically excluded property is to be isolated. Then, if substantially all of the assets of the two partnerships are of a like-kind, the exchange qualifies under § 1031. “Substantially all” of the assets means 90% of the gross assets of the partnership exclusive of cash, securities, and stock. These excluded assets are treated similar to debt assumed and relieved, and are netted against each other to the extent each is in existence in the exchanging partnerships. If the amount of these assets received exceeds the amount exchanged, then gain will be recognized to the full extent it would be without regard to § 1031. See Like-Kind Exchanges of Partnership Interests, 4 A.L.I. FEDERAL INCOME TAX PROJECT 36 (1980).

63. See supra note 25.

64. The personal property consisted of furniture and fixtures in the amount of $13,500. The total value of the partnership interest received by Pappas was $74,750. Therefore, dissimilar assets represented more than 18% of the partnership and would therefore not qualify for nonrecognition treatment under the A.L.I. rules. See supra note 62.

65. This was the first alternative mentioned in dealing with the effect of excluded property in the underlying assets of partnership interests exchanged. Pappas v. Commissioner, 78 T.C. 1078 (1982).

66. Id. This was the second alternative mentioned in the same context as note 65, supra.

67. Id. at 1089. See infra text accompanying notes 75-86, for the court’s treatment of excess liabilities assumed.

68. Id. at 1088.
tion that an insubstantial amount of dissimilar assets in the underlying property of the partnership interests exchanged has no effect on section 1031 treatment.

Further support for this approach is found in Long.69 The court, when discussing its justification for deciding that gain recognized under section 1031(b) should be computed using the entity theory, stated: "[D]ue to the requirement that the underlying assets of each partnership be of a like-kind, there is a substantial probability that the balance sheets of the exchanged partnerships will be similar, thus reducing any inequities which might otherwise result from the entity approach. . . .{70

The court thus appears to indicate that in order for the underlying assets to be of a like-kind, they need not be identical but only similar. Moreover, the underlying assets in both partnerships whose interests were exchanged in Long consisted of personality and realty of varying amounts.71 The court stated that "it [was] beyond dispute that the predominant underlying properties of both partnerships were substantially the same, as they were both residential rental apartment complexes held for investment."72 Therefore, neither the existence of personality in an exchange predominantly of realty nor the inequality of amounts of personality in each exchanged partnership interest precluded section 1031 treatment.73

The result in Long and Pappas appears to be consistent with the court's second-tier analysis regarding the existence of parenthetically excluded property.74 However, the court's caveat in Long is equally applicable to the contribution of dissimilar property to the partnership as it is to the contribution of excluded assets at or near the time of exchange. Presumably, the court would not hesitate to apply the "substance over form" doctrine should it determine abuse had occurred.

Relief of Liabilities

Assuming that an exchange passes both tiers of the court's analysis and no other property is received in the exchange outside of the partnership in-

70. Id. (emphasis added). See also infra note 82 for other reasons advanced by the court to support application of the entity theory.
71. Id. More than 14% of the underlying assets exchanged consisted of furniture and fixtures, while the personality comprising the assets received was only around 3%.
72. Id. at 1069. This statement contains additional significance in light of the fact that there were also § 1031(a) excluded assets in the underlying property.
73. In this regard, Long may be distinguished from Pappas by the fact that in Pappas personality existed only in the underlying assets of the partnership interest received and not in the interest exchanged. Long could merely be giving effect to the rationale promulgated in Rev. Rul. 57-365, 1957-2 C.B. 52, which held that an exchange of all the realty and personality (except inventory and securities) comprising the business of one operating telephone company for all the similar assets of another such company is an exchange to which § 1031 applies.

Though Pappas apparently exceeds the parameters of the ruling, the proposition that an exchange of a partnership holding primarily personality for one holding primarily realty will not qualify under § 1031(a) can be reasonably asserted. Such an exchange would thus fail the second-tier analysis.

74. See supra text accompanying notes 49-61.
interest constituting boot, the transaction is not necessarily tax-free. Gain may still be recognized by virtue of section 1031(d) if a taxpayer is relieved of liabilities associated with the underlying assets of the exchanged partnership interest.

In Long the court addressed for the first time the problem of whether gain realized on a partnership exchange pursuant to section 1031(d) should be recognized to the extent of boot received as provided in section 1031(b) and, if so, exactly how the amount of boot should be computed. In this case, Long was a 50% owner in both a general partnership and a joint venture.\(^7\) Essentially the same individuals owned the remaining 50% interest in each entity. The principal underlying assets of both the venture and partnership were mortgaged rental real estate. The original agreements in both entities provided that liabilities would be allocated to partners in the same proportions as their respective partnership interests.\(^8\) Therefore, Long was allocated 50% of each partnership’s liabilities. Within six weeks prior to the exchange, simultaneous amendments were made to the agreements of both the partnership and joint venture. The partnership amendment resulted in a reduction of liability allocated to Long’s exchanged partnership interest. The joint venture amendment affecting the interest received by Long resulted in an increase in his liability for an amount in excess of a certain sum. The bottom-line effect was that Long decreased his liabilities relieved as a result of the exchange while possessing the ability to increase the amount of debt assumed in the joint venture by incurring additional liabilities. Two days before the exchange occurred, the joint venture incurred additional debt in the amount of $400,000.\(^7\) The interests were then exchanged, and Long reported no gain from the exchange on his income tax return. The Commissioner assessed a deficiency arising from unreported capital gain in the amount of $918,938, alleging that section 1031 was inapplicable.

After determining that the exchange involved like-kind general partnership interests, the court then applied the second tier of its analysis.\(^8\) In applying the “substance over form” test to the underlying assets, the court concluded that although the predominant underlying properties of both partnerships were substantially the same,\(^9\) the $400,000 liability was incurred in an attempt to avoid receipt of boot by Long.\(^8\) However, this manipulative effort did not

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75. Actually, the case involved two taxpayers who each owned a 25% interest. In order to avoid confusion and because the facts and results are identical for both taxpayers, reference shall be made only to Long.

76. Furthermore, profits and losses were shared in the same manner in each entity. Accordingly, Long was allocated 50% of the profits and the losses of each entity.

77. This debt was the result of a note. The cash proceeds were shown on the balance sheet as “investments,” while the liability appeared as a “note payable.”


79. The underlying assets consisted primarily of residential rental apartment complexes held for investment.

80. The court noted that the effect of the partnership amendment was to substantially reduce Long’s shared liabilities. It further noted that he appropriately reduced his basis under I.R.C. § 723 to reflect this debt reduction. The court found that, although the amount of gain to be
cause the transaction to fall outside the purview of section 1031. Therefore, the
court had to determine how gain under section 1031(b) should be com-
puted, i.e., whether it should be done on a partnership-asset-by-partnership-
asset basis or on a partnership-entity basis, which would result in recognition
only to the extent provided in subchapter K of the Internal Revenue Code.\textsuperscript{41}

The court held that gain recognized should be determined by applying the
entity theory because it had consistently relied on this theory when analyzing
whether an exchange qualified under section 1031(a).\textsuperscript{42} Consequently, Long
was required to recognize gain on the exchange to the extent that liabilities
of which he was relieved in the transfer of his interest in the partnership ex-
ceeded the liabilities assumed on receipt of the interest in the joint venture.
In determining the amount of liabilities relieved and assumed, the court decided
that the amendments had no substance other than their impact on the taxability
of the transaction and would not be given effect.\textsuperscript{43} The court then analyzed
the nature of the liabilities and allocated them according to the regulations
and the original terms of the partnership and joint venture agreements.\textsuperscript{44} This
resulted in a determination that Long had been relieved of net liabilities in
the amount of $1,049,734, instead of $6,680 as he had reported.\textsuperscript{44} Under Long,

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recognized is preserved due to the basic reduction, the partners could always avoid receipt of
boot by manipulating liabilities so long as they had sufficient basis to absorb the decrease in
liabilities. For this reason, the court concluded that the amendments still had substantial tax
effect despite the fact that the partner's basis reflected the debt reduction.

81. Subchapter K is the portion of the Internal Revenue Code dealing with the taxation of
partnerships.

82. Long v. Commissioner, 77 T.C. 1045, 1071 (1981). Other reasons advanced were: (1)
it respects the special recognition provisions within subchapter K; (2) numerous technical prob-
lems that would arise if the aggregate approach were adopted are avoided. See supra text accom-
ppanying note 70.

83. Long argued that substantial business reasons existed for the amendments because of
his concern with his personal liability in the floundering, cash-poor partnerships. Also, Long
gave up his right to guaranteed payments from the partnership in order to have his liabilities
reduced. Furthermore, it was argued that the $400,000 liability incurred immediately before the
exchange was for the purpose of repairing the roof of the rental complex. None of these conten-
tions withstood the court's scrutiny.

84. In computing the amount of liabilities relieved in the partnership interest exchanged, the
court made an unusual allocation. It first noted the general rule in Treas. Reg. $ 1.752-1(e)
whereby liabilities of a general partnership are allocated according to the partners' ratio for shar-
ing losses under the partnership agreement. It then mentioned the provision in the regulation
requiring nonrecourse liabilities to be allocated in the same proportion as the partners share profits.

After this discussion, the court decided that liabilities in the partnership exchanged should
be allocated in the ratio that the partners shared losses. This is significant in light of the fact
that, of the $2,815,658 liability associated with the underlying partnership property, $2,400,000
was nonrecourse. However, the court took notice of the fact that three of the partners were
personally liable on the debt to the extent of $1,191,458. Accordingly, the court indicated that the
personal guaranty of a nonrecourse loan by individual partners, outside their capacity as
partners, transforms the debt so that partnership liabilities should be allocated in a recourse fashion.

The effect of this approach in Long was immaterial because profits and losses in each entity
were shared 50-50. However, if the court were to adopt this approach generally, the effect on
the basis computation to limited partners would be much more substantial. See 1 W. McKee,
W. Nelson & R. Whitmire, supra note 6 at ¶ 8.01-8.04.

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the "substance over form" doctrine will be applied to all facets of a partnership exchange and amendments should be supported by valid business reasons. 86

Because the court in Long held that gain must be recognized under section 1031(b) in this type of transaction, the question then arose as to whether Long was entitled to a step-up in the basis of his partnership interest for any portion of the gain recognized. The amount of depreciation allowed on the joint venture assets acquired was dependent on the answer to this question. The court held that, in order to be consistent with the partnership entity approach as applied to section 1031, section 1031(d) allowed a full-basis step-up. 87 The interplay of the subchapter K provisions in the court's analysis merits attention. The court began at section 1031(d), which provides that the basis of the taxpayer's joint venture interest is equal to the basis in the property exchanged, a 50% partnership interest, plus the gain recognized on the exchange. 88 However, as a result of the exchange of a 50% interest, the joint venture terminated under section 708(b)(1)(B). 89 The termination's effect was that the old joint venture made a liquidating distribution to the taxpayer in which no gain or loss was recognized to the partners under section 731(a), or to the joint venture under section 731(b). 90 Section 732(b) provides that the bases of joint venture assets distributed are stepped-up to equal the adjusted basis of the partner's interest. A new joint venture is deemed to be formed which is then entitled to this stepped-up basis under section 723 upon the constructive contribution of that property by the partner. Instead of dissolving this new entity, Long continued to operate it as a new 50% owner. In continuing the joint venture's operation, Long would thus receive the benefit of depreciation deductions on the entire amount of the stepped-up bases. 91

86. In a footnote, the court in Long stated that amendments to the partnership agreement by the partners are permitted and will be effective if they are adopted prior to or at the time the partnership return is due for that taxable year. I.R.C. § 761(c). The court further stated that all allocations must have economic substance and cited Holladay v. Commissioner, 72 T.C. 571 (1979), aff'd 649 F.2d 1176 (5th Cir. 1981); Kresser v. Commissioner, 54 T.C. 1621 (1970). 77 T.C. at 1078. See I.R.C. § 704(b)(2).
88. Id. at 1083.
89. I.R.C. § 708(b)(1)(B). The Commissioner did not argue that the termination caused the transaction to fall outside § 1031. The court stated that it considered this result correct in view of Treas. Reg. § 1.708-1(b)(1)(iv). Id.
90. I.R.C. §§ 731(a), (b). See Treas. Reg. § 1.708-1(b)(1)(iv), where the sequence of the termination of the old partnership and formation of the new partnership as a result of termination is explained.
91. I.R.C. § 732(b).
92. I.R.C. § 723.
93. The Commissioner argued that such treatment would result in a double benefit to Long to the extent of his negative capital account in the partnership whose interest he exchanged. This negative balance, argued the Commissioner, was a result of the allocation of losses in the partnership and represented prior tax deductions. The court disposed of this argument by explaining that it used the alternative method authorized in Code § 705(b) to compute the taxpayer's basis. Therefore, Long's negative bases, in effect, increased his gain recognized.
The court then observed that, at the price of a tax at capital gains rates, taxpayers would be entitled to greater depreciation deductions, which would then offset future ordinary income. Although this observation is correct, section 751 mitigates the value of such a result. That section provides that amounts realized from certain property by a partner in exchange for all or a part of his partnership interest will be considered as being derived from ordinary income property. This is an exception to the general rule found in section 741 that a partnership interest is to be treated as a capital asset. Section 751 property includes appreciated inventory items and unrealized receivables. Unrealized receivables is defined to encompass depreciation recapture under sections 1245 and 1250. Therefore, if the underlying assets of an exchanged partnership interest consist of inventory or other property subject to recapture, and gain is recognized on the exchange, capital gain is converted into ordinary income. Because, in general, very few partnerships can exist without the presence of such assets, it would seem rare for a taxpayer to receive a basis step-up pursuant to sections 1031(b) and (d) solely from gain recognized at capital gain rates.

Conclusion

Case law firmly establishes that an exchange of partnership interests may be initially considered for section 1031 treatment. In determining whether the

94. I.R.C. § 751.
95. Section 751 assets have posed an intriguing problem in considering the effects of tax-free exchanges of partnership interests. The problem arises when an exchange occurs and qualifies at the first-tier analysis. However, included in the underlying assets is property described by § 751. Assuming that, under § 1031, no gain realized should otherwise be recognized, there appears to be no authority for carrying over the § 751 ordinary-income taint to the acquired partnership assets.

It has been argued that this property should be treated separately from the § 1031 transaction with gain recognized appropriately. Another possibility would be that § 751 overrides § 1031. Neither of these possibilities seems likely. The first is improbable because it would be inconsistent with the entity approach repeatedly applied by the court. In the context of parenthetically excluded property located in the partnerships, the court has used the entity approach so that this property is not separately treated as resulting in gain recognized. The existence of § 751 property in the underlying assets should be deemed analogous. The second possibility is unlikely because this section could be construed to be a characterization section just as § 741 was in Pappas. Therefore, it would never come into operation unless gain was recognized under § 1031.

Perhaps the more likely approach would be for the court to consider the nature of the partnership activities. If the nature of the activities mandates the presence of such assets and the amounts are reasonable, § 1031 should still apply. However, if the court determines that the existence of such assets constitutes an abuse, then the transaction should fall outside § 1031. In any event, it should be remembered that the purpose of § 751 is to prevent the conversion of ordinary income into capital gain. For the court to adopt this approach without somehow maintaining this taint would be to circumvent that purpose.

96. I.R.C. §§ 1245, 1250.
97. A definite unintended benefit occurred in Long, where the taxpayer was allowed to take accelerated depreciation on the underlying assets exchanged. However, the Commissioner failed to assert the § 751 issue, which would have resulted in a portion of the capital gain recognized from the § 1031 exchange being ordinary income. Long v. Commissioner, 77 T.C. 1045, 1081 (1981).
transaction qualifies for nonrecognition under that section, the Tax Court has consistently used a two-tier analysis. The court recognizes the partnership entities in its first-tier analysis, while piercing this entity in applying its second-tier analysis.

In the first-tier analysis, the court has repeatedly held exchanges of general partnership interests to be "like-kind" under section 1031(a). However, even in this situation, care should be taken to assure that the general partnership interest cannot be recharacterized as a limited one, thereby precluding nonrecognition treatment; this statement is supported by the court's holding in Meyer that an exchange of a general partnership interest in return for a limited interest does not qualify as like-kind, even though the underlying assets of the partnerships are identical. Moreover, when limited partnership interests are exchanged, the Commissioner may contend that the interests constitute "securities" and thus should be denied section 1031 treatment because of the parenthetical language in section 1031(a).

After Long and Pappas, the court's methodology in its second-tier analysis appears consistent and should provide a degree of predictability. Nonetheless, in examining the underlying assets of the partnerships to determine if they are of a like-kind, the court applies a test that is more certain in theory than in application. Although capable of being phrased in a variety of ways, the standard seems to be that if substantially all of the assets could be exchanged tax-free outside the partnership form, the exchange will qualify for nonrecognition treatment though the assets are located within a partnership. Another formulation is that if the underlying property of the partnerships is substantially the same and includes an insignificant amount of excluded assets, the exchange qualifies for section 1031 treatment.

In any event, the test applied by the court is definitely not one of mathematical certainty. The analysis begs the question as to what amount of assets must qualify for nonrecognition before it constitutes "substantially all of the partnership's assets." In making this determination, the court focuses on prevention of abuse through utilization of the partnership form to accomplish a tax-free transaction that could not have otherwise been achieved. However, the court recognizes that because of the inherent nature of the partnership form, the operative requirements of section 1031 must be applied in a less stringent fashion. Thus, a reasonable amount of inventory or cash on hand within the partnership does not constitute abuse. A "reasonable amount" of such assets will probably depend upon the nature of the partnership activities. Accordingly, if the amount of dissimilar assets or excluded property is not unreasonable, their presence will not automatically be deemed abusive and result in gain recognition under section 1031(b).

Furthermore, the judicial test does not distinguish the effect of the presence of excluded assets, and it appears such assets are simply included with the underlying dissimilar property in determining whether the requisite amount of assets would qualify for a tax-free exchange but for the partnership.98 The

98. This result is not only logical but consistent with § 1031(b), which provides, in effect, that both dissimilar and excluded assets are to be treated as boot. There is, therefore, no ap-