

Like-Kind Exchange Corner

By *Mary B. Foster*

The Same Taxpayer Requirement of Code Secs. 1031 and 1033: Part III—Partnerships and LLCs



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Introduction

In the November–December 2009 edition and the March–April 2010 edition of the *Journal of Passthrough Entities*, I discussed the same taxpayer requirement under Code Secs. 1031 and 1033.¹ This requirement provides that the taxpayer who disposed of the relinquished property in an exchange under Code Sec. 1031, or the converted property in an involuntary conversion under Code Sec. 1033 (referred to as the relinquished property in this column), must acquire the new property (referred to as the replacement property in this column) to qualify for the gain deferral. If another taxpayer acquires the replacement property, the exchange or involuntary conversion will not be eligible for nonrecognition of gain treatment under these Code provisions. In the previous columns, I discussed the same taxpayer requirement for married individuals, including disregarded entities formed by the married individuals, and estates and trusts. In this column, I examine how the same taxpayer requirement applies to partnerships and LLCs, including disregarded entities.

Acquisition of Replacement Property by Same Partnership

If a partnership (including a multi-member LLC that has not elected to be taxed as a corporation) is the owner of the relinquished property at the time of the involuntary conversion, then the same partnership must elect deferral under Code Sec. 1033 and acquire the replacement property. The partners may not elect deferral or acquire the replacement property in their



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individual names as a liquidation of their partnership interests.² Likewise, if the relinquished property is owned by individuals, they cannot acquire their replacement property in a partnership.³

The same rule applies to exchanges under Code Sec. 1031.⁴ The partnership that disposes of the relinquished property must acquire the replacement property. The individual partners cannot acquire the replacement property.

Both Code Secs. 1031 and 1033(g) require that the replacement property be held for use in a trade or business or for investment. The IRS has interpreted this “held for” requirement to mean that the partnership acquiring the replacement property must have the intent to hold it for a significant period of time, rather than an immediate distribution to the partners.⁵ In contrast, Code Sec. 1033(a) does not have a “held for” requirement. Therefore, it appears that the partnership may acquire replacement properties that are similar or related in use to the relinquished property, thus satisfying Code Sec. 1033(a), and immediately distribute the replacement properties to the partners.⁶ A partnership also may be able to distribute the relinquished property out to the partners as tenants-in-common prior to the transfer to the condemning authority. Then, each partner may elect separately under Code Sec. 1033 to replace that partner’s undivided interest in the relinquished property with replacement property that is similar or related in use.⁷

Replacement Period Conversions to Different Type of Entity

The partnership that disposed of the relinquished property may want to acquire the replacement property in a different type of entity. For example, a general partnership may want to convert to a limited liability entity, such as a limited partnership or LLC, prior to the acquisition of the replacement property. The IRS has issued several revenue rulings holding that the conversion of a general partnership to a limited partnership, or a partnership to an LLC, does

not cause a termination of the partnership and does not cause the partnership taxable year to close.⁸ Thus, a replacement period conversion does not create a new taxpayer for the purposes of Code Sec. 1031 or 1033. The successor entity is treated as both the transferor of the relinquished property and transferee of the replacement property.⁹

Importantly, in each of the revenue rulings discussed above, each partner’s total percentage interest in the partnership’s profits, losses, and capital remained the same after the conversion. Therefore, if a partnership wants to convert to an LLC during the replacement period in a Code Sec. 1031 or 1033 transaction, no partners should be admitted or should withdraw at the time of the conversion. The business of the partnership should continue to be carried on after the conversion, but this should not be a significant issue if the partnership is acquiring replacement property that is like-kind or similar or related in use. Also note that a change in the partners’ share of liabilities as a result of the conversion

may trigger gain to a partner whose share of liabilities or at risk basis is reduced.¹⁰

Replacement Period Partner Changes

The ownership interests in the partnership or LLC may change during the replacement period without affecting the Code Sec. 1031 or 1033 transaction, provided the changes do not result in a termination under Code Sec. 708(b)(1)(B). This termination occurs when 50 percent or more of interests in partnership capital and profits are sold or exchanged within a 12-month period. Therefore, one partner may sell its partnership interest to another partner, or to a new partner, during the replacement period in a Code Sec. 1031 or 1033 transaction, provided the transferor partner does not own 50 percent or more of the capital and profits interest in the partnership. A new partner also may be admitted to the partnership without a termination if the new partner, instead of purchasing another partner’s interest, contributes capital or services under Code Sec. 721.¹¹

Presumably, a new partnership resulting from a replacement period termination under Code Sec.

If another taxpayer acquires the replacement property, the exchange or involuntary conversion will not be eligible for nonrecognition of gain treatment under [Code Secs. 1031 and 1033].

708(b)(1)(B) could not acquire the replacement property under either Code Sec. 1031 or 1033. The issue has never been ruled on by the courts or the IRS and thus it should be avoided. A private letter ruling was issued recently on a partnership termination that occurred after an exchange. The IRS ruled that that termination of the partnership did not affect the prior exchange because the transfers of partnership interests that gave rise to the termination were essentially involuntary. The ruling indicates that the IRS does consider a termination under Code Sec. 708(b)(1)(B), caused by voluntary transfers of partnership interests, a problem for a Code Sec. 1031 transaction (and therefore undoubtedly also a Code Sec. 1033 replacement.)¹²

Replacement Period Partnership Mergers and Divisions

Code Sec. 708(b)(2) provides special rules for mergers and divisions of partnership that do not result in partnership terminations.

Divisions

In the case of a division of a partnership into two or more partnerships, any resulting partnership is considered a continuing partnership if the resulting partnership has at least two members who owned more than 50 percent in the capital and profits of the prior partnership.¹³ Any other resulting partnerships are considered new partnerships.¹⁴ The IRS ruled that if the dividing partnership disposes of the relinquished property and makes an election under Code Sec. 1033 to replace the property, the continuing partnerships may acquire the replacement property.¹⁵

There is no similar ruling under Code Sec. 1031; however, the same rationale would seem to support allowing the exchange to be completed by a continuing partnership. Further, the IRS has issued rulings allowing corporate mergers during the replacement property in a Code Sec. 1031 exchange, as discussed below.

Mergers

In the case of the merger or consolidation of two or more partnerships, the resulting partnership is considered the continuing partnership of any merging or consolidating partnership whose members own more than 50 percent in the capital and profits of the resulting partnership.¹⁶ If two or more partner-

ships could be the continuing partnership, then the merging partnership that contributes assets with the greatest fair market value (net of liabilities) is the continuing partnership. There can only be one continuing partnership, so the other partnerships would be considered terminated.¹⁷ Code Sec. 381 provides for the carryover of tax attributes in corporate mergers, and the IRS has ruled that a successor corporation in a nontaxable reorganization covered by Code Sec. 381 may acquire the replacement property in a Code Sec. 1031 exchange when the predecessor corporation disposed of the relinquished property.¹⁸ While there is no comparable provision for partnerships, presumably, if the continuing partnership were the transferor of the relinquished property, it could acquire the replacement property under Code Sec. 1031 or 1033. If the partnership that disposed of relinquished property prior to the merger is terminated in the merger, the replacement would most likely fail because the partnership will no longer exist and cannot acquire replacement property.

Single-Member LLCs and Disregarded Partnerships

A taxpayer can acquire the replacement property in a disregarded entity, such as a single-member LLC (SMLLC).¹⁹ The taxpayer, as the sole member of the SMLLC, would be treated as both the transferor and the transferee for the purposes of Code Secs. 1031 and 1033 and the acquisition of the replacement property by the SMLLC would be deemed an acquisition by the taxpayer.

The IRS also has ruled that an LLC with two members will be considered a SMLLC and, therefore, the same taxpayer that disposed of the relinquished property, if the sole role of one of the members is to prevent the other member from placing the LLC into bankruptcy. This is helpful if the lender for the replacement property wants a bankruptcy remote entity. In the ruling, the limited role member had no interest in the LLC's profits or losses nor any management rights other than the limited right regarding bankruptcy. Therefore, the IRS ruled that the LLC would not be treated as a partnership for federal tax purposes.²⁰

A taxpayer can acquire 100 percent of the interests of a disregarded entity as replacement property under Code Sec. 1031 or 1033 in lieu of acquiring the property itself, perhaps saving on transfer taxes and other costs. The IRS has ruled that the acquisi-

tion of all the membership interests in SMLLC is treated as the purchase of the assets held by the LLC for purposes of Code Sec. 1031.²¹ This allows a taxpayer to acquire the membership interests rather than the assets themselves. Private letter rulings also have been issued allowing an exchange accommodation titleholder under Rev. Proc. 2000-37 to form as an SMLLC for the purpose of acquiring the replacement property and constructing improvements, with the SMLLC then transferred to the taxpayer as replacement property to complete the Code Sec. 1031 exchange.²²

Based on the analysis contained in these rulings, the taxpayer's transfer of 100 percent of the ownership interest in a disregarded entity that holds legal title to the relinquished property should constitute the transfer of the relinquished property for the purposes of Code Sec. 1031.

Partnership as a Disregarded Entity

In Revenue Ruling 2004-77, the IRS ruled that a partnership will be considered a disregarded entity when the partners consist of partner X and a disregarded entity wholly owned by partner X. For example, a partnership is disregarded for federal tax purposes if its partners are X corporation and Y LLC, whose sole member is X corporation.²³

Relying on Revenue Ruling 2004-77, the IRS issued a private letter ruling holding that a taxpayer can acquire 100 percent of the partnership interests in a limited partnership that owns the replacement property in a Code Sec. 1031 exchange, rather than acquiring direct title to the replacement property itself. The ruling states that pursuant to Rev. Rul. 99-6, the limited partnership is considered to have terminated under Code Sec. 708(b)(1)(A) and made a liquidating distribution of its assets to its partners, and the taxpayer is treated as having acquired 100 percent of such assets from the partners for federal tax purposes, rather than as having acquired partnership interests from the partners. The ruling also holds that this transaction is not an exchange of partnership interests in violation of Code Sec. 1031(a)(2)(D).²⁴

Conclusion

The same partnership that disposes of the relinquished property must acquire the replacement property under Code Secs. 1031. The same partnership also must make an election to replace involuntarily converted property under Code Sec. 1033. However, partners may leave or join the partnership, and mergers and divisions may occur, during the replacement period. Further, SMLLCs can be used to acquire the replacement property to accomplish goals such as liability protection and avoidance of transfer taxes.

ENDNOTES

¹ Mary B. Foster, Like-Kind Exchange Corner, *The Same Taxpayer Requirement of Code Secs. 1031 and 1033*, J. PASSTHROUGH ENTITIES, Nov.–Dec. 2009, at 19; Mary B. Foster, Like-Kind Exchange Corner, *The Same Taxpayer Requirement of Code Secs. 1031 and 1033: Part II—Estates and Trusts*, J. PASSTHROUGH ENTITIES, Mar.–Apr. 2010, at 19.
² *T.K. McManus*, CA-9, 78-2 USTC ¶9748, 583 F.2d 443 (cert. denied); *M. Demirjian*, CA-3, 72-1 USTC ¶9281, 457 F.2d 1; *M. Fuchs*, 80 TC 506, Dec. 39,943 (1983); Rev. Rul. 66-191, 1966-2 CB 300.
³ TAM 8750001 (Jul. 22, 1987); LTR 8527090 (Apr. 15, 1985).
⁴ *D.G. Chase*, 92 TC 874, Dec. 45,634 (1989); TAM 9818003 (Dec. 24, 1997).

⁵ TAM 9645005 (Jul. 23, 1996); Rev. Rul. 75-292; 1975-2 CB 333; Rev. Rul. 77-337, 1977-2 CB 305.
⁶ LTR 8735026 (May 29, 1987); LTR 9028046 (Apr. 10, 1990); Rev. Rul. 55-517, 1955-2 CB 297.
⁷ LTR 8527090 (Apr. 15, 1985); *but see* TAM 9645005 (Jul. 23, 1996).
⁸ Rev. Rul. 84-52, 1984-1 CB 157; Rev. Rul. 95-37, 1995-1 CB 130; Rev. Rul. 95-55, 1995-2 CB 313.
⁹ LTR 199935065 (May 28, 1999).
¹⁰ Code Secs. 752 and 465.
¹¹ Reg. §1.708-1(b)(1)(ii).
¹² LTR 200812012 (Mar. 21, 2008).
¹³ Code Sec. 708(b)(2)(B).
¹⁴ Reg. §1.708-1(d)(1).

¹⁵ See LTR 200921009 (Feb. 13, 2009) and LTR 8244124 (Aug. 9, 1982).
¹⁶ Code Sec. 708(b)(2)(A).
¹⁷ Reg. §1.708-1(c)(1).
¹⁸ LTR 9152010 (Sep. 13, 1991), LTR 9751012 (Sep. 15, 1997) and LTR 200151017 (Dec. 12, 2001).
¹⁹ LTR 9751012 (Sep. 15, 1997) and LTR 200732012 (Aug. 10, 2007). This assumes the SMLLC has not elected corporate status.
²⁰ LTR 199911033 (Mar. 19, 1999).
²¹ LTR 200118023 (Jan. 31, 2001).
²² LTR 200712013 (Nov. 20, 2006) and LTR 200251008 (Sep. 11, 2002).
²³ Rev. Rul. 2004-77, 2004-2 CB 119.
²⁴ LTR 200807005 (Feb. 15, 2008).

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