

**Joint Report on IRC Section 1031 Open Issues
Involving Partnerships**

The following report represents the individual views of the members of the Section of Taxation who prepared them and does not represent the position of the American Bar Association or the Section of Taxation.

The comments in this Joint Report (“Report”) were prepared by individual members of the following three Tax Section Committees: Sales, Exchanges and Basis; Partnerships; and Real Estate. Principal responsibility was exercised by Mary Foster, Ron Platner, and John Schmalz, and the report reflects their personal views. Substantive contributions were made by Adam Handler and Lou Weller. The Report was reviewed by Howard Levine of the Section’s Committee on Government Submissions and by Stanley Blend, Council Director for the Committee on Sales, Exchanges and Basis.

Although members of the Section of Taxation who participated in preparing the Report have clients who would be affected by the federal tax principles addressed by the Report or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of the Report.

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JOINT REPORT ON IRC SECTION 1031 OPEN ISSUES INVOLVING PARTNERSHIPS

Introduction

The purpose of this Report is to propose answers to a number of open questions that arise in the context of partnership Section 1031¹ exchanges. The issues discussed in this Report represent questions that arise in everyday practice and have not been resolved by published guidance.

Many like kind exchanges are undertaken regularly by taxpayers of relatively modest means. Many of these exchanges are frequently consummated by partners with property distributed to them by partnerships in anticipation of an exchange. The goal of this Report is to encourage the Internal Revenue Service to issue guidance that addresses areas of concern to taxpayers attempting to understand and apply Section 1031 in a partnership context.

It is common for taxpayers holding property through a partnership (including limited liability companies treated as partnerships for income tax purposes) to attempt: (i) to dissolve and liquidate the partnership in order to permit each partner to separately sell or consummate a subsequent Section 1031 exchange, (ii) to distribute undivided interests in the relinquished property to some partners to allow partner-specific 1031 exchanges, or (iii) to use special allocations at the partnership level to reflect the scope of participation by specific partners in partnership level exchanges.

Clarification is needed of the legal standards to be applied when: (i) a relinquished property was formerly held by a partnership and distributed to one or more partners in anticipation of an exchange, (ii) a relinquished property is held by a partnership and only some of the partners desire to participate (indirectly) in the exchange, and (iii) a replacement property received in an exchange is transferred to a partnership. In our experience, each of these transactions are common and existing guidelines do not lead to clear conclusions. Further, published guidance also does not address how Section 752(b) and Section 465 should be applied in the context of exchanges.

The liquidation of an entire partnership and the distribution of co-tenancy interests in a prospective relinquished property can be successfully accomplished for income tax purposes, but for commercial reasons such transactions are often complicated and represent an unduly expensive route for preparing for a Section 1031 exchange. For example, a closely held partnership holding encumbered and improved real estate must typically obtain lender consent before liquidating and distributing co-tenancy interests to its former partners. Property management issues involving tenants of the prospective relinquished property and vendors of various services to the property often complicate resulting co-tenancy arrangements.

¹ All references are to the Internal Revenue Code of 1986, as amended. References in this report to a “partnership” refer to any unincorporated organization that is treated as a partnership for income tax purposes, including a limited liability company that does not elect to be treated as an association taxable as a corporation.

Tax characterization issues also complicate the day-to-day operations of a co-tenancy arrangement because of the uncertainty about the scope of a valid protective Section 761 election out of Subchapter K.

Such complications often compel taxpayers to seek other means of accomplishing the same end result: a Section 1031 exchange.

Many of the legal issues confronting taxpayers would become irrelevant or far less important if the “qualified use”² standard for Section 1031 exchanges was clarified to make clear that: (i) qualified use by a distributing partnership or a contributing partner can be attributed to the distributee partner or recipient partnership where the new owner’s basis is determined by reference to the old owner’s basis and (ii) by recognizing that partnership level exchanges with boot can be combined with valid Section 704(b) allocations to effectively retire or partially liquidate the interest of a partner with boot proceeds.

This report is presented in a question and answer format to identify the commonly encountered issues in applying Section 1031 in the partnership context. The answers represent the recommended clarification to address these partnership Section 1031 open issues.

Discussion of Partnership Section 1031 Open Issues: Questions and Answers

Q-1 Can like-kind property satisfy the “qualified use” requirement, under the following circumstances:

a. If the relinquished property is distributed to one or more partners by a partnership in anticipation of the distributee’s transfer of the property in an exchange?

b. If like-kind replacement property received by a partnership in an exchange is distributed to one or more partners by the partnership immediately following the exchange?

c. If like-kind property is contributed to a partnership in anticipation of the partnership’s transfer of the property in an exchange?

d. If like-kind property is contributed to a partnership following its receipt by the contributing partner as replacement property in an exchange?

A-1 Yes, in all cases, if the person or entity who owns the relinquished or replacement property immediately before the exchange does not intend to liquidate the investment or to convert the relinquished property or replacement property to a personal purpose, the taxpayer engaging in the exchange has satisfied the qualified use requirement. Transferring either replacement property or prospective relinquished property to a partner who does not sell the property or convert it to a personal use should not bar the satisfaction of the qualified use

² Section 1031(a)(1) provides for nonrecognition of gain or loss when property held for productive use in a trade or business or for investment is exchanged solely for like-kind property to be held for either productive use in a trade or business or for investment. The statutory phrase “held either for productive use in a trade or business or for investment” is referred to in this Report as the “qualified use” requirement.

standard by distributor/partnership or the distributee/partner. Similarly, if a partner contributes prospective relinquished property or replacement property to a partnership in a transfer governed by Section 721, the receiving partnership or the contributing partner should be viewed as satisfying the qualified use standard.

The IRS has been unwilling to attribute an entity's qualified use to the taxpayer before or after a tax free transfer to or from the entity. For example, in Rev. Rul. 75-292, the IRS found that the taxpayer had not held the replacement property for qualified use when, immediately after the exchange, the taxpayer contributed the replacement property to his wholly-owned corporation. In Rev. Rul. 77-337, the IRS found that a taxpayer had not held the relinquished property for a qualified use when the taxpayer received the relinquished property as a liquidating distribution from his wholly-owned corporation and then immediately exchanged the relinquished property for a replacement property.

Similarly, in Rev. Rul. 84-121, 1984-2 C.B. 168, the IRS ruled that property acquired by a taxpayer for purposes of acquiring another property upon exercise of an option could not be transferred to the owner of the optimal property in a Section 1031 exchange because the taxpayer had not held the relinquished property for a qualified use.

The IRS has cited some of these rulings in a partnership context in TAM 9645005, in ruling that a partner who received a distribution of partnership property immediately prior to a sale under Section 1033(g) had not held the property for a qualified use. (Section 1033(g) has a qualified use requirement similar to Section 1031(a)(1)).

However, it is not necessary to "attribute" a predecessor owner's purpose in holding a property to a subsequent holder of the same property in order to satisfy the qualified use requirement. In *Bolker v. Commissioner*, 181 TC 782 (1983), aff'd 760 F.2d 1039 (CA9 1985), the taxpayer entered into an exchange agreement the same day he received the relinquished property in a liquidating distribution from his wholly-owned corporation in a tax free liquidation governed by former Section 333. The exchange closed three months later. The Court held that if a taxpayer does not intend to liquidate the relinquished property or use it for personal pursuits, then the taxpayer satisfies the qualified use requirement. Thus, the most appropriate interpretation of the qualified use requirement is an interpretation that facilitates like kind exchanges that do not represent an effort to "cash in" the taxpayer's investment.

In *Maloney v. Commissioner*, 93 TC 89 (1989),³ a corporation exchanged real property and, at the time of the exchange, intended to liquidate and distribute the replacement property to

³ *Bolker* and *Maloney* involved corporate liquidations. A corporation is always considered an entity separate from its shareholders. A partnership, however, is a pass-through entity and in many contexts is considered an aggregation of individual partners rather than an entity separate from its partners. For example, the partners of a general partnership may elect under Section 761(a) to be taxed as owners of undivided interests in the underlying assets of the partnership. No such election is available to a corporation or its shareholders. Under Section 701, "persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities." Certain elections under Section 703 are also made at the individual partner level, rather than at the partnership level. Section 731 generally allows tax free distributions from a partnership; no similar provision exists for corporations. Given the aggregate nature of a partnership, the rationale that the taxpayer is merely continuing its investment in another form is more convincing in the partnership context than in the corporate context.

its shareholders. One month following the exchange, the corporation did liquidate (tax free under former Section 333), distributing the replacement property to the shareholders. The Court found that the exchange satisfied the qualified use requirement because there was continuity of investment even though there was a change in the form of ownership. The taxpayers had not “cashed in” their investment and continued to have an economic interest in the same investment. The Court concluded that a Section 1031 exchange may be preceded or followed by a tax free transfer under Section 721.

The IRS did not appeal or issue a nonacquiescence with respect to the *Maloney* case, which may suggest that the IRS may not be prepared to litigate this issue, notwithstanding the earlier holdings in Rev. Rul. 75-292, Rev. Rul. 77-337, and Rev. Rul. 84-121.

In *Magneson v. Commissioner*, 753 F.2d 1490 (9th Cir. 1985) aff’d 81 TC 767 (1983), the taxpayer exchanged a fee interest in real property for an undivided interest in another property in a Section 1031 exchange. Immediately thereafter, the taxpayer contributed the replacement property to a partnership in a transaction governed by Section 721. The contribution of the replacement property to the partnership was treated as a continuation of the taxpayer’s investment in another form and not a liquidation of the taxpayer’s investment, and the Section 1031 exchange was respected by the courts.

There is no compelling policy reason why Section 1031 should be administered in a manner that imports a vague or indefinite temporal holding period requirement into Section 1031(a)(1). The statute does not literally impose a durational requirement.

The absence of taxpayer intent to liquidate an investment in the subject property or convert the subject property to a personal use should be recognized as the appropriate standard for satisfying the “qualified use” test of Section 1031. Such a standard is most consistent with the judicial precedents.⁴

Q-2 Can a Section 1031 deferred exchange be completed if the partnership that transferred the relinquished property is terminated under Section 708(b)(1)(B) because of the sale or exchange of 50% or more of the capital or profits interest in the partnership?

A-2 Yes, the new partnership that arises out of the Section 708(b)(1)(B) termination can acquire the replacement property to complete the Section 1031 exchange.

Under Treas. Reg. §1.708-1(b)(1)(iv), upon the termination of a partnership, the terminating partnership contributes all of its assets to a new partnership in exchange for an

⁴ For example, in *Fred S. Wagensen v. Commissioner*, 74 T.C. 653 (1980), a valid Section 1031 exchange was recognized where the taxpayer had no "current plans" to make a gift, which occurred approximately 9 months after the exchange. In contrast, in *Click v. Commissioner*, 78 T.C. 253 at 234 (1982), a gift made soon after an exchange invalidated the exchange because the Tax Court held that the taxpayer had acquired the replacement property to convert it to a personal use. In *124 Front Street, Inc. v. Commission*, 65 TC 6 (1975), the taxpayer borrowed funds from an unrelated corporation and used the loan proceeds to acquire a property upon exercise of an option. The taxpayer transferred the recently acquired property to the unrelated corporation, which had provided the loan, in an exchange for like-kind real property within approximately six months after the option property was acquired. The Tax Court rejected the government's argument that the exchange was not governed by Section 1031.

interest in the new partnership and, immediately thereafter, the terminated partnership distributes the interests in the new partnership to the purchasing partner and to the remaining partners in the terminated partnership in proportion to their respective interests in the terminated partnership.

Under Sections 704(b), 704(c) and 737, the effects of a Section 708(b)(1)(B) termination are disregarded. The capital accounts of the partners in the terminated partnership are carried over to the new partnership. Treas. Reg. §1.704-1(b)(2)(iv)(1). See also Treas. Reg. §1.704-3(a)(3)(i), §1.737-2(a). The holding period and the character of the terminated partnership's assets in the hands of the new partnership are determined under the general rules for contributions of property to a partnership. Treas. Reg. §1.708-1(b)(1)(iv).

The overall effect of Treas. Reg. §1.708-1(b)(1)(iv) and the related changes made under other regulations has been to minimize or eliminate any artificial adverse effect of a partnership termination caused by Section 708(b)(1)(B). There is no policy reason why a like-kind exchange, which "straddles" a Section 708(b)(1)(B) termination, should fail to be governed by Section 1031 because a "new" partnership completes the exchange. The new partnership should be viewed as a continuation of the old partnership for purposes of Section 1031.

The principles of this treatment can be illustrated by the following example:

Example No 2(a)

ABCD, a limited liability company ("ABCD") owns Whiteacre, which has an adjusted basis of \$100,000 and a fair market value of \$400,000. ABCD is treated as a partnership for income tax purposes.

A has a 40% interest in the capital, profits and losses of ABCD. Each of B, C and D have a 20% interest in the capital, profits and losses of ABCD. ABCD begins a deferred exchange and transfer Whiteacre to a qualified intermediary under an exchange agreement. Thereafter, A and B sell their interests in ABCD to X for \$240,000 before ABCD acquires Blackacre as a replacement property. A and B collectively own a 60% interest in the profits and capital of ABCD. Consequently, the purchase by X of the 60% interest causes the ABCD partnership to terminate under Section 708(b)(1)(B). Nevertheless, for purposes of Section 1031, the new partnership of XCD is viewed as a continuation of ABCD. The result in this illustration would not change if, alternatively, X acquired the 60% interest in ABCD immediately before the transfer of Whiteacre or immediately after the acquisition of Blackacre.^{5 6}

⁵ For the reasons stated in the first section of this Report, the "new" partnership should be viewed as continuing the entity level investment in the like-kind property. The fact that A and B "cashed out" in a taxable sale should not affect the partnership level treatment.

⁶ In *Long v. Commissioner*, 77 TC 1045 (1981), the court stated in footnote 25 that a termination under Sec. 708 prior to an exchange should not cause the exchange to fall outside of Section 1031. The court stated that "we consider this to be the correct result especially in view of the statement contained in sec. 1.708-1(b)(1)(iv), Income Tax Regs."

Q-3 In connection with a Section 1031 exchange can a partnership make special allocations of the “boot” gain recognized pursuant to Section 1031(b) exchange, including historical pre-contribution gain governed by Section 704(c)?

Part One- Section 704(b) Issue

A-3 We believe that gain recognized by a partnership in a partially tax deferred exchange governed by Section 1031(b) may be specially allocated to one or more partners under Section 704(b), if such recognized gain is appropriately reflected in the partners’ respective capital accounts and such allocation has substantial economic effect.

The most appropriate application of Section 704(b) is illustrated in the following examples, which illustrate circumstances where a Section 704(b) allocation should be recognized. However, not all attempted allocations of “boot” gain should be recognized, as noted in the last example in this portion of the Report.

Example No. 3(a)

ABC limited liability company (“LLC”) was formed in 199X by individuals A, B and C, each of whom contributed \$100,000 in cash in exchange for a one-third interest in the profits, losses and capital of LLC. ABC is treated as a partnership.

The operating agreement for LLC provides that allocations of income, gain, loss and deduction are reflected in the member’s respective capital accounts, and liquidating distributions, including in complete retirement or redemption of a member’s interest would be made in accordance with the member’s capital account balances.

LLC purchased Whiteacre, a rental office building, for \$300,000 in cash.

In 200X, the adjusted basis of Whiteacre has been reduced to \$200,000 through straight line depreciation deductions and the fair market value of Whiteacre had increased to \$600,000. At that time, A agrees with B and C that A’s one-third interest in LLC should be fully retired and liquidated for the amount of \$200,000, representing one-third of the fair market value of the assets of LLC.

LLC enters into a contract to exchange Whiteacre for Blackacre, which has a fair market value of \$400,000, plus \$200,000 in cash. Immediately before the exchange, the capital account of each of A, B and C is \$66,667. The LLC has no other significant assets and no liabilities at that time.

Immediately prior to the closing of the exchange, A, B and C agree to modify their operating agreement for LLC such that \$133,333 of the “boot” gain recognized in the exchange for Blackacre and \$200,000 in cash is specially allocated to A, thereby increasing her capital account to \$200,000. (In the Section 1031(b) exchange, LLC will realize \$400,000 of gain, of which \$200,000 will be recognized.) The remaining \$66,667 of “boot” gain is allocated equally to B and C. A also agrees to accept a cash distribution of \$200,000 from LLC in complete retirement of A’s interest in the LLC. B and C agree to continue the LLC indefinitely as equal

members, and B and C intend that the LLC will hold Blackacre for productive use in LLC's trade or business.

The disproportionate allocation of \$133,333 of gain to A and \$66,667 to B and C should be recognized as a valid Section 704(b) allocation because the allocation has substantial economic effect and is consistent with the respective partner interests of A, B and C under two alternative tax analyses.

(i) Value Equals Basis Analysis

The economic effect of the disproportionate allocation of boot gain to A is substantial because the second to the last sentence in Treas. Reg. § 1.704-1(b)(2)(iii)(c) (i.e., the so-called "value-equals-basis rule") provides that "for purposes of § 1.704-1(b)(2)(iii), the adjusted basis of partnership property...will be presumed to be the fair market value of such property, and adjustments to the adjusted basis of such property will be presumed to be matched by corresponding changes in such property's fair market value. Thus, there can not be a strong likelihood that the economic effect of an allocation (or allocations) will be largely offset by gain or loss from the disposition of property." Accordingly, because at the time of the special gain allocation, it is assumed that the fair market value and adjusted basis of Blackacre are \$200,000 and neither the IRS nor ABC could presume the existence of \$200,000 of gain inherent in Blackacre to "charge back" to B and C. Thus, B and C are deemed to bear the burden of the disproportionate gain allocation to A in the form of a relatively smaller increase in the capital account balances of B and C. Objective facts indicating that Blackacre actually retained its fair market of \$400,000 are, therefore, ignored under the value-equals-basis analysis.

(ii) Alternative Economic Analysis

Alternatively, the special allocations to A, B and C have "substantial economic effect," within the meaning of Treas. Reg. § 1.704-1(b)(2)(i), because the allocations will be reflected in the capital accounts of A, B and C, and A's adjusted capital account balance of \$200,000 will determine the liquidating distributions made to A. Treas. Reg. § 1.704-1(b)(2)(ii)(b)(2).

The economic effect of the allocation made to A is "substantial" because, as an objective economic matter, A will not participate in the future economic profits or losses attributable to Blackacre after his interest in LLC is retired.

Under Treas. Reg. § 1.704-1(b)(2)(iii)(a), the economic effect of an allocation is "substantial" if there is a "reasonable possibility" that the allocation will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences. There is more than a "reasonable possibility" that the special allocation to A will affect the dollar amount received by A because B and C, as the remaining partners, will incur all of the economic risk and potential profit associated with Blackacre, the replacement property.

Treas. Reg. § 1.704-1(b)(2)(iii)(b) and (c) describe two types of special allocations that are not recognized as "substantial." The first type is referred to as a "shifting tax consequence" allocation. (For example, allocating all taxable interest income to one partner and all tax-exempt interest income to another partner in the same dollar amount.) Such allocations fail because they result in net increases and decreases in capital accounts that do not differ substantially from the

net increase and decrease that would occur in the absence of the special allocation. See Treas. Reg. §1.704-1(b)(5) example (6), (7)(ii), (iii) and (10)(ii).

The second type of “insubstantial allocation” is the so-called “transitory allocation,” where the original allocation will be largely offset by one or more offsetting allocations. (For example, an allocation of tax loss in one year to a partner combined with a promise that an offsetting allocation of taxable income will be made in the following year.) The allocation of gain to A attributable to \$133,333 of the cash boot is neither a prohibited “transitory allocation” nor a “shifting tax consequence” allocation.

Finally, Treas. Reg. §1.704-1(b)(2)(iii) establishes a “catchall” prohibition against any allocation if “...at the time the allocation becomes part of the partnership agreement, (1) the after-tax economic consequence of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocations were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequence of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation were not contained in the partnership agreement.” Example (5) and Example (9) of Treas. Reg. §1.704-1(b)(5) illustrate the application of the “catchall” prohibition. Neither of these examples suggest that a special allocation of gain to a retiring partner should be barred by the “catchall” prohibition.

The application of this “catchall” prohibition is unclear in the context of a retiring partner; however, a pragmatic approach would not apply the prohibition in this instance, where there is a strong likelihood that the after-tax economic consequences to A, as a former partner of LLC, will be substantially diminished by the special allocation to A because A will no longer participate in the partnership’s future gains or losses attributable to its replacement property investment in Blackacre. Permitting a special allocation of gain in this situation also will simplify the application of Section 704(b) in the context of the retirement of a partner who does not wish to participate in a partnership’s continuing investment in a Partnership’s Section 1031 replacement property. Thus, under the alternative analysis, the special allocation to A also should be recognized.

Example No. 3(b)

Assume the same facts in example 3(a), but assume that ABC amended its operating agreement before the exchange in order to allocate all of the \$200,000 “boot” gain to A, increasing her capital account to \$266,667. However, upon liquidation and retirement of A’s interest, she receives only \$200,000 in cash. The purported special allocation of the entire \$200,000 of boot gain to A would not be recognized, and only \$133,333 of such disproportionate allocation to A would be recognized, which would increase her capital account balance to \$200,000.

Part Two - Section 704(c) Issue

If property contributed to a partnership has a basis to the contributing partner (a “Section 704(c) Partner”) that is more or less than its fair market value, the property has a built in gain or loss and such property is referred to as “Section 704(c) property.” Treas. Reg. §1.704-3(a)(3).⁷

A partnership that disposes of property with a built in gain or loss is required to allocate any remaining built in gain or loss to the 704(c) Partner in order to prevent the shifting of tax consequences among partners with respect to such built in gain or loss. Section 704(c)(1)(A).

Treas. Reg. §1.704-3 permits the adoption of various methods to allocate for built in gain or loss, including the traditional method and so-called curative methods.

If a partnership disposes of Section 704(c) property in a Section 1031 nonrecognition transaction in which no gain or loss is recognized, Treas. Reg. §1.704-3(a)(8) requires that the replacement property be treated as Section 704(c) property. If gain or loss is recognized in such an exchange, Treas. Reg. §1.704-3(a)(8) states that “appropriate adjustments” are required. The regulations do not state how such appropriate adjustments should be determined.

The appropriate adjustments contemplated by Section 704(c) should include (i) treating any gain allocated to the Section 704(c) Partner as Section 704(b) gain to the extent there is book gain recognized in the Section 1031 exchange and (ii) treating any taxable gain in excess of the book gain as Section 704(c) gain allocated to the Section 704(c) Partner in order to reduce book and tax disparities. These principles can be illustrated as follows:

Example No. 3(c)

As the Section 704(c) Partner, A contributes nondepreciable property with an adjusted basis of zero and a fair market value of \$1,000 and B and C each contribute cash in the amount of \$1,000 to the ABC Partnership (“ABC”). A, B and C are equal one-third partners. The \$2,000 in cash is expended by ABC to pay costs that are required to be capitalized and which increase the adjusted basis of the Section 704(c) property owned by the ABC to \$2,000. After the expenditures, the fair market value of the Section 704(c) property is \$5,000.

ABC is using the traditional method under Treas. Reg. §1.704-3(b)(1).

ABC decides to dispose of the Section 704(c) property in a Section 1031 exchange for like kind replacement property in a transaction in which no book or tax gain or loss is recognized. Under such circumstances, the replacement property with a fair market value of \$5,000 and adjusted basis of \$2,000 will be treated as Section 704(c) property and A will continue as the Section 704(c) Partner with respect to the \$1,000 of built in gain.

If, alternatively, ABC disposes of the Section 704(c) property in a partially taxable exchange for replacement property with a fair market value of \$3,000 and cash of \$2,000, \$2,000 of book gain and an equal amount of taxable gain would be recognized by ABC as follows: The

⁷ This Report refers to the partner contributing Section 704(c) property as the “704(c) Partner”.

book gain recognized on the exchange is \$2,000 (i.e., the lesser of the book gain realized \$2,000 (amount realized of \$5,000 minus book basis of \$3,000) or the boot received which is \$2,000), and the tax gain recognized is \$2,000 (i.e., the lesser of the tax gain realized \$3,000 (amount realized of \$5,000 minus tax basis of \$2,000) or the boot received \$2,000). Since the book gain recognized and the tax gain recognized are equal, the entire \$2,000 of tax gain must be allocated under Section 704(b) in the same manner that the book gain is allocated. Because there is no difference between the tax and book gain recognized, this is not an appropriate occasion to take into account any of the book/tax disparity attributable to A. The adjusted basis of the replacement property would be \$2,000, and the full \$1,000 of potential Section 704(c) gain would be preserved.

Example 3(d)

A and B form a “50-50” partnership (“AB”). A contributes business property with an adjusted basis of \$4,000 and a fair market value of \$10,000 reflecting built in gain of \$6,000. The property’s book value to the partnership following the contribution is thus \$10,000. B contributes cash in the amount of \$10,000. AB adopts the traditional method. The Section 704(c) property depreciates for book purposes at an annual rate of 10% (\$1,000 per year), and all of the tax depreciation (i.e., \$400) is allocated to B. AB disposes of the Section 704(c) property contributed by A at the beginning of the second year of AB (when the adjusted basis in the property is \$3,600) in a cash sale for \$10,000, and AB thereby realizes taxable gain of \$6,400 and book gain of \$1,000. \$5,400 of the tax gain must be allocated to A to account for A’s built-in gain. The remaining \$1,000 of gain is allocated equally between A and B. Treas. Reg. §1.704-3(b)(2) example (1)(iii).

If the sale had been for cash of \$9,000, there would have been no book gain and all of the \$5,400 tax gain would be allocated to A.

In contrast, assume AB disposes of the Section 704(c) property in a Section 1031 exchange at the beginning of its second year when its value is \$9,000, and AB receives replacement property with a value of \$8,000 and cash in the amount of \$1,000. AB realizes and recognizes \$1,000 of taxable gain in the exchange, and no book gain is recognized (i.e., the value of the consideration received in the exchange is equal to the book value of the relinquished property of \$9,000). The replacement property has an adjusted basis of \$3,600. After the exchange, the excess of the fair market value of the replacement property over its adjusted basis is sufficient to account for all of A’s remaining “built in gain.” However, the \$1,000 of taxable gain must be allocated solely to A because such allocation reduces A’s book/tax capital account disparity. After such an allocation, the book capital accounts of A and B would continue to be \$9,500 each (i.e., original \$10,000 less 50% of \$1,000 book depreciation). The tax capital account of A would be increased from \$4,000 to \$5,000. The tax capital account of B would be \$9,600 (i.e., \$10,000 decreased by \$400 of depreciation).

Q-4 When a partnership engages in a Section 1031 deferred exchange that is not completed until after the end of the partnership’s tax year, is any temporary reduction or a “gap” in the amount of partnership liabilities required to be treated as a “distribution of money to the partners” under Section 752(b), if upon completion of the deferred exchange the amount of

liabilities encumbering the replacement property is equal to or greater than the debt encumbering the relinquished property?

A-4 No, the temporary reduction in the amount of debt does not result in a constructive distribution of money under Section 752(b) even if the deferred exchange straddles two tax periods.

Where each party to the exchange either assumes a liability of the other party or acquires property subject to a liability, the so-called “liability netting rule” provides that consideration given in the form of an assumption of a liability or a receipt of property subject to a liability (or, for that matter, cash or other property) is offset against consideration received in the form of an assumption of a liability or a transfer of property subject to a liability. Under this rule, a taxpayer who receives boot (i.e., a taxpayer whose liability is assumed or who transfers property subject to liability) by surrendering property can offset the boot by any boot given, including cash, but a taxpayer who receives cash consideration (to equalize net values) cannot offset the cash boot received by boot given in the form of providing mortgage relief by assuming or receiving mortgaged property subject to existing debt. Treas. Reg. § 1.1031(d)-2, examples (1) and (2). The tax consequences of the liability netting rule are the same for simultaneous and deferred exchanges. Treas. Reg. § 1.1031(k)-1(j)(3), Example 5.

Under Treas. Reg. § 1.752-1(f), only the net decrease in a partner’s share of liabilities is treated as a distribution from the partnership when a partner incurs both an increase and a decrease in liabilities as a result of a “single transaction.” A deferred exchange should be treated as a “single transaction” for purposes of Section 752(b), with the result that a temporary “gap” in the amount a partner’s share of liabilities attributable to the relinquished property and the replacement property should not result in a constructive distribution of money under Section 752(b).

Q-5 When a partnership engages in a Section 1031 deferred exchange, does Section 465(e) trigger the realization of income because of a “gap” or temporary reduction in the amount the taxpayer has at risk, if upon completion of the deferred exchange the amount the taxpayer has at risk is equal to or greater than the amount at risk immediately before the transfer of the relinquished property?

A-5 No. Section 465(e) requires the recapture of previously allowed losses when the amount a taxpayer has at risk in an activity is reduced below zero. To the extent the amount at risk is reduced below zero, the taxpayer recognizes income. However, a temporary reduction in the amount at risk does not trigger income recognition under Section 465(e) because a deferred exchange is treated as an integrated or single transaction, notwithstanding the fact that the deferred exchange straddles two tax periods.

Under Section 465, the amount at risk cannot be less than zero. Losses are suspended after the amount at risk reaches zero. Distribution of cash, reductions in liabilities and various other events that would otherwise result in a negative at risk amount trigger income recognition under Section 465(c)(1)(B). This income recognition is intended to recapture previously deducted losses.

The recapture of income under Section 465(e) generates a suspended loss in the same amount, which has the effect of placing the taxpayer in the same place if the losses had originally been suspended because the at risk amount had reached zero.

The at risk rules are applied to the separate “activities” of a taxpayer. The general rule is that activities are not aggregated. However, if a taxpayer actively participates in the management of a trade or business, then all activities comprising the trade or business are aggregated for purposes of the at risk rules, as provided by Section 465(c)(3)(B)(i), (2)(B)(ii).⁸

The determination of a taxpayer’s at risk amount on a separate activity basis is not addressed under regulations in the context of an exchange. The appropriate treatment should be that the replacement property should be considered the continuation of the same activity, and a partnership level exchange should not be treated as an event that triggers income under Section 465.

⁸ The classification of activities under Section 469 may be different than their classification under Section 465.