Care Needed In Co-Ownership Like-Kind Exchanges

Neil Harl
Iowa State University, harl@iastate.edu

Follow this and additional works at: http://lib.dr.iastate.edu/aglawdigest

Part of the Agricultural and Resource Economics Commons, Agricultural Economics Commons, Agriculture Law Commons, and the Public Economics Commons

Recommended Citation
Available at: http://lib.dr.iastate.edu/aglawdigest/vol10/iss14/1

This Article is brought to you for free and open access by the Journals at Iowa State University Digital Repository. It has been accepted for inclusion in Agricultural Law Digest by an authorized editor of Iowa State University Digital Repository. For more information, please contact digirep@iastate.edu.
CARE NEEDED IN CO-OWNERSHIP LIKE-KIND EXCHANGES

— by Neil E. Harl*

Tax-free, like-kind exchanges\(^1\) have become a popular and widely used way to dispose of low-basis, high value assets.\(^2\) A recent private letter ruling, however, has raised a red flag for some like-kind exchanges involving co-owned property.\(^3\) The risk is sufficiently great to suggest that every proposed like-kind exchange involving co-owned property should be reviewed with care before the exchange is completed.

Partnership interests not eligible

Under the like-kind exchange rules, in general no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for property of like-kind which is to be held either for productive use in a trade or business or for investment.\(^4\) However, it is crystal clear that interests in a partnership are not considered like-kind and do not qualify for tax-free exchange treatment.\(^5\) The key question is what entities are considered “partnerships” for this purpose (which would not be eligible participants in a like-kind exchange)\(^6\) and which arrangements constitute mere co-ownership of property which would be eligible.\(^7\)

Private letter ruling

In a 1997 private letter ruling,\(^8\) two brothers owned equal co-ownership interests in an arrangement which itself owned ten rental properties, all of which involved ownership of land. The brothers represented that they had never executed a partnership agreement and did not consider the arrangement as involving anything other than co-ownership of the properties.\(^9\) However, for five consecutive years, the brothers reported all net income and losses on a Form 1065, partnership income tax return.\(^10\) Management of the properties had been performed by a property management corporation of which the brothers were equal shareholders but were no longer employees.\(^11\)

Because of “irreconcilable differences” between the brothers, the two proposed a like-kind exchange between themselves involving nine of the properties. After the exchange, six properties would be owned entirely by one brother and three by the other. The tenth property would continue to be owned by the brothers as co-owners.

The Internal Revenue Service, confronted by a ruling request in the matter, acknowledged that an exchange of partnership interests would not qualify for like-kind exchange treatment.\(^12\) The Service, accordingly, focused on whether the brothers as co-owners intended to create a partnership, as evidenced by their actions, despite the lack of characterization of the arrangement as a partnership.\(^13\)

As evidence of their intention to create a partnership—result for federal income tax purposes, the Service concluded that the filing of partnership returns for five years

---

* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.
indicated such an intention. Therefore, the arrangement was not an eligible participant in a like-kind exchange because it was deemed to be a partnership rather than a mere co-ownership of property.

Other authority

But is the 1997 private letter ruling with its singular emphasis on filing a federal income tax return, consistent with other authority?

A 1975 revenue ruling, Rev. Rul. 75-374, also involved the question of whether the co-owners of real property, in this case an apartment project, should be treated as a partnership for federal income tax purposes. Citing the regulations, the ruling notes that mere co-ownership of property that is maintained, kept in repair and rented to others did not constitute a partnership. The ruling further states that tenants in common may be treated as partners if they actively carry on a trade, business, financial operation or venture, and divide the profits from the arrangement. The ruling concludes that the two owners, one an insurance company and the other an investment trust, were to be treated as co-owners and not as partners. The ruling explained that the furnishing of customary services in connection with the maintenance and repair of an apartment project would not transform a co-ownership arrangement into a partnership but the furnishing of additional services would render a co-ownership a partnership if the additional services are furnished directly by the co-owners or through their agent. The ruling observed that, in the facts of the ruling, the co-owners were not furnishing the additional services either directly or through an agent—an unrelated corporation was responsible for managing the project.

Lessons to be learned

The conclusion of the 1997 private letter ruling is worrisome for many farm and ranch exchanges involving co-ownership of property. The ruling identifies four key factors—(1) there was co-ownership of property; (2) management services exceeded “customary” services for maintenance and repair; (3) the additional services were by the co-owners or by an agent; and (4) the co-owners filed a partnership income tax return.

In a typical co-ownership of farmland rented under a crop-share or livestock share lease, the lease is not ordinarily considered to be a partnership but the involvement in management often exceeds the customary management level, at least compared to a cash rent lease and the involvement is often by the co-owners themselves or by a farm manager as agent. Thus, if the co-owners file a federal partnership income tax return (which many do as a matter of convenience), like-kind exchange treatment may be in jeopardy.

Therefore, in instances where a like-kind exchange is contemplated, it is important not to file a Form 1065, partnership income tax return. A shift to a cash rent lease would not appear to be necessary but it would be advisable to keep management activities to the “customary” level for the years preceding the exchange.

FOOTNOTES

6. Id.
7. See I.R.C. § 1031(a)(1).
9. Id.
10. Id.
11. Id.
14. Id.
15. Id.
20. Id.
21. Id.
22. See Harl, Agricultural Law § 41.06 (1999) (imputation of activities by agent to property owner as principal).
23. Id.
25. Id.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

CHAPTER 13-ALM § 13.03.*

ELIGIBILITY. The debtors, husband and wife, originally filed for Chapter 13 but both debtors died before filing a plan. The debtors claimed their 140 acre residence as an exempt rural homestead. The debtor’s attorney filed a motion to convert the case to Chapter 7, which the court originally granted. On reconsideration, the court vacated the conversion of the case, holding that the decedent’s estate could not convert a case to Chapter 7 because the estate could not file for Chapter 7. The court emphasized that the estate could not be a debtor because the estate did not have income to fund the plan. The court also dismissed the Chapter 13 case on the grounds that the estate would be better administered in state probate court to give the creditors the best payment on their claims. In re Spiser, 232 B.R. 669 (Bankr. N.D. Tex. 1999).