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Recommended Citation
Available at: http://lib.dr.iastate.edu/aglawdigest/vol27/iss13/1
Like-Kind Exchanges With “Partnerships”: Use Great Care

-by Neil E. Harl*

In an amendment enacted as part of the Deficit Reduction Act of 1984,1 “interests in a partnership” have not been eligible for a like-kind exchange.2 The key issue is what is meant by “interests in a partnership” (which run afoul of the statute enacted in 1984) and which arrangements merely constitute co-ownership of property (which are eligible for a like-kind exchange).

The key ruling

Without much question, the key ruling on this issue, whether an arrangement was a co-ownership of properties or represented “interests in a partnership,” was a letter ruling issued in 1997.3 That ruling involved an exchange of 10 rental properties between two brothers who owned equal co-ownership interests in the arrangement. The exchange, precipitated by “irreconcilable differences,” resulted in one brother owning six properties and the other brother owning three properties.4 The brothers continued to have co-ownership of the tenth property.5

The brothers, for five consecutive years, reported all net income and losses on a Form 1065, partnership income tax return, which IRS found to be objectionable. The brothers argued that the use of a Form 1065 was a matter of convenience and should not be viewed as an indication that the arrangement was a partnership. The brothers argued that they had never executed a partnership agreement and had not held the arrangement to be a partnership.

On audit, the Internal Revenue Service concluded that the filing of a partnership tax return (Form 1065) for five years (Form 1065) was an indication that the brothers intended to form a partnership. The IRS conclusion was that the exchange was not eligible for like-kind exchange treatment inasmuch as the rental properties were partnership interests rather than mere co-ownership of the properties. The ruling identified four key factors in reaching that conclusion – (1) there was co-ownership of the properties; (2) management services exceeded what IRS considered to be “customary” services for maintenance and repair (which tended to tilt the scale toward a finding of a partnership characterization; (3) the additional services were provided by the two brothers or by an agent which indicated that it was operated as a business more than as an investment only; and (4) as noted, the brothers filed a partnership income tax return even though it was done as a convenience.

An attempt to resolve the issue

The 1997 letter ruling set off a barrage of criticism from the public. This author was (and is) convinced that the private letter ruling was an example of the Internal Revenue

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Service engaging itself in “making law” rather than interpreting the law as enacted by the Congress and signed into law by the President of the United States as is mandated by the United States Constitution. This author is convinced that had the issue been litigated the outcome would very likely have been different. The unfairness of this approach to achieving an IRS objective is that targeted taxpayers who either cannot or choose not to litigate basically set the stage for an extension of tax law for all taxpayers without a modicum of constitutional protection.

In 2002 the Internal Revenue Service issued a revenue procedure addressing the circumstances under which advance rulings would be issued in situations involving co-ownership of rental real property in an arrangement classified under local law as a tenancy in common. It is noted that the Congress (and the President) in the 1984 amendment did not mention co-ownership in limiting like-kind exchanges. The reference was to “interests in a partnership,” not interests in “co-ownership arrangements.”

Even though 14 years have elapsed since the issuance of the revenue procedure, Congress has yet to curb the IRS move in this area.

The messages in Rev. Proc. 2002-22

In 2002, IRS issued Rev. Rul. 2002-22 which specified the conditions to be met for an advance ruling – (1) title must be held in tenancy in common under local law (rather than by an entity); (2) the number of co-owners is to be 35 or fewer; (3) the co-owners must not file a partnership or corporate tax return, execute an agreement identifying the co-owners as partners, shareholders or other members of a business entity or otherwise hold themselves out as a partnership or other form of business entity; (4) the co-owners may enter into a “limited co-ownership agreement” that may run with the land (for example, an agreement specifying that a co-owner must first offer the co-ownership interest to other co-owners; (5) the co-owners must retain the right to approve the hiring of any manager, sale or other disposition, lease or the creation of a blanket lien; (6) each co-owner must have the rights of transfer, encumbrance and partition without the approval of others; (7) in the event the property is sold, any debt must be satisfied before distribution of the proceeds to the co-owners; (8) each co-owner must share in all revenues generated by the property and all costs in proportion to the co-owner’s interest; (9) the co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests; (10) a co-owner may issue an option to purchase a co-owner’s undivided interest (a “call” option) if the price for the call option reflects fair market value of the property as of the time of exercise of the option; (11) the co-owner’s activities must be limited to those “customarily performed” in connection with maintenance and repair of the property; (12) the co-owners may enter into management or brokerage agreements; (13) all leasing agreements must be bona fide leases for federal tax purposes and reflect the fair market value for the use of the property; (14) the lender, if any, with respect to the debt encumbering the property or debt incurred to acquire the co-ownership interest must not be a related person; (15) payments, if any, to a “sponsor” for the acquisition of the co-ownership interest and the fees paid must reflect fair market value and may not depend on income or profits derived from the property.

ENDNOTES

4 Id. See 4 Harl, note 2 supra, § 27.04[1][b][i].
7 U.S. Const. Art 1, § 8.
9 I.R.C. § 1031(a)(2)(D).
10 2002-1 C.B. 733.

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