OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL CC:DOM:FS

SUBJECT: INQUIRY REGARDING APPLICATION OF I.R.C. ' 1031

This Field Service Advice responds to your memorandum dated June 1, 1999 requesting post review of a memorandum to Examination dated May 27, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer:
Owner:
A:
B:
C:
D:
E:
F:
Qualified Intermediary:
X:
Property 1:
Property 2:

Property 3:
Property 4:

a:
b:
c:
d:
e:
f:
g:
h:

Year 1:
Year 2:
Year 3:
Year 4:
Year 5:
Year 6:
Year 7:

Date 1:
Date 2:
Date 3:
Date 4:
Date 5:
Date 6:
Date 7:

ISSUE(S):

1. Whether the transaction between Taxpayer and A in Year 6 constituted Taxpayer=s sale of a partnership interest so as to disqualify it as a like-kind exchange of property under I.R.C. ' 1031(a)(2)(D) .

2. Whether the transaction gives rise to cancellation of indebtedness income.

3. Assuming the transaction between Taxpayer and A in Year 6 is not characterized as the Taxpayer=s sale of a partnership interest, does the transaction otherwise qualify as a like-kind exchange of property.

CONCLUSION(S):

1. The facts of this case indicate that the transaction between Taxpayer and A was, in substance, a sale by Taxpayer of its partnership interest in X to A.

2. Whether the transaction gives rise to cancellation of indebtedness income depends upon whether the amount of canceled debt exceeded the value of the property interest conveyed. As a general matter, when a taxpayer agrees to surrender or transfer property in exchange for the cancellation of debt the transaction is treated as a sale and the income is treated as gain rather than cancellation of indebtedness income. In this case, the facts are consistent with a sale of Taxpayer=s interest in exchange for cash and cancellation or assumption of debt. Accordingly, the transaction would have produced COD income only to the extent the fair market value of the property transferred was less than the amount of debt discharged.

3. We do not have sufficient information to say with certainty whether some part of the exchange would qualify as a like-kind exchange under the scenario you have outlined. However, only property that was properly identified within the 45 day identification period would be treated as like-kind to the relinquished property.

<u>FACTS:</u>

We rely on the facts set forth in your memorandum.

Taxpayer is a partnership formed in October of Year 1. Owner had a 95% interest in Taxpayer as the general partner and a 2.5% interest as a limited partner. On Date 1, E, a corporation wholly owned by Owner, acquired the remaining 2.5% limited partnership interest in Taxpayer.

In Year 1, Taxpayer owned certain real property and had the rights to acquire adjacent property. Taxpayer entered into a joint venture with B and formed X to construct, develop and operate two buildings, Property 1 and Property 2. Taxpayer contributed its title to the real property and its rights to acquire the adjacent property in exchange for a 50% interest in X. B contributed cash in an amount equal to the value of Taxpayer=s contribution for a 50% interest in X.

In Year 2, A acquired B=s interest in X. At this point, A became responsible for providing financing to X to fund the construction and development of Property 1 and Property 2. The joint venture agreement was modified to give A the right to dissolve X under certain delineated circumstances. In addition, the ownership structure was changed such that A now owned 70% of X and Taxpayer owned the remaining 30%. Taxpayer was responsible for the day-to-day operations of X, while A was responsible for accounting functions. By

Year 3, because of additional contributions, A owned 75% of X. Property 1 was completed and began operations in Year 3. Property 2 began operations in Year 4.

Pursuant to its agreement, A loaned X certain amounts. According to an auditor=s report for X as of December 31, Year 5, X=s current liabilities included notes payable to A in the amount of b. X=s long-term liabilities at the same date included a note payable to A in the amount of c. All notes were secured by X=s real property.

Early in Year 5, problems between Taxpayer and A arose. The parties attempted to negotiate an arrangement whereby A would purchase Taxpayer=s interest in X. These negotiations broke down and eventually A indicated a desire to invoke its right under the joint venture agreement to dissolve X. In November Year 5, A offered to purchase Taxpayer=s interest in X for d. After further discussions the parties agreed to a selling price in the amount of e.

On Date 1, Taxpayer and A executed the agreement to dissolve X. Pursuant to the agreement, X filed a statement electing to be excluded as of January 1, Year 5, from the provisions of Subchapter K of the Internal Revenue Code. The Commissioner received the election on Date 2. The dissolution agreement provided for Taxpayer and A to receive X=s undivided interest in X=s assets, including Property 1 and Property 2. An index of the closing documents indicates that on Date 1, X deeded Taxpayer and A interests of 25% and 75%, respectively, in Property 1 and Property 2. A statement on one of the closing documents expressly indicates that the partnership grant deeds were not deeds in lieu of foreclosure.

Also on Date 1, Taxpayer and A executed three agreements of purchase and sale. The first covered the sale by Taxpayer of its interest in X=s assets other than Property 1 and Property 2; the second covered the sale by Taxpayer of its interest in Property 1; and the third covered the sale by Taxpayer of its interest in Property 2.

The first agreement indicated that assets other than Property 1 and Property 2 were sold at the agreed upon purchase price of e. This agreement purported to allocate the purchase price of e between these assets.

The second agreement, for the sale of Taxpayer=s interest in Property 1, indicated that the purchase price for Property 1 was f. As payment, A relieved Taxpayer of its share of the liability for the debts and encumbrances to which the property was subject as of April 30, Year 6. As part of the agreement, A agreed to cooperate with Taxpayer in setting up a deferred exchange under I.R.C. ' 1031. Accordingly, Taxpayer and A entered into an exchange agreement with Qualified Intermediary. Pursuant to the exchange agreement, on Date 1, Taxpayer executed a deed conveying its 25% interest in Property 1 to Qualified

Intermediary, which transferred the 25% interest to A. Taxpayer agreed to identify replacement property within 45 days and Qualified Intermediary agreed to use its best efforts to purchase the replacement property within 180 days. On its income tax return for Year 6, Taxpayer reported gain from the sale of Property 1 in the amount of g.

The third agreement, for the sale of Taxpayer's interest in Property 2, indicated that the purchase price for Property 2 was h. As with the prior agreement, A paid the purchase price by A relieving Taxpayer of its share of the liability for the debts and encumbrances to which the property was subject as of April 30, Year 6. As with the transfer of Taxpayer's interest in Property 1, Taxpayer intended the transfer of its interest in Property 2 to be accomplished via a deferred exchange under section 1031. Consequently, the parties entered into a second exchange agreement with Qualified Intermediary providing that Taxpayer agreed to identify replacement property within 45 days and Qualified Intermediary agreed to use its best efforts to purchase the replacement property within 180 days. On Date 1, Taxpayer executed a deed conveying its 25% interest in Property 2 to Qualified Intermediary. Qualified Intermediary then transferred the 25% interest in Property 2 to A.

The 45 day period for identifying replacement property expired on Date 3. The 180 day period for the receipt of the identified replacement property expired on Date 7. Although Taxpayer did not identify replacement property for Property 1 within the 45 day period, Taxpayer timely identified replacement property for Property 2 on Date 3. One of the three identified properties, Property 4, was eventually acquired.

On Date 4, C, a limited partnership, was formed for the purpose of acquiring and managing Property 3. Property 3 consisted of land and improvements. C was owned by Owner and D, a corporation formed one day prior to Date 4 and wholly owned by Owner. Owner retained a 99% limited partnership interest in C and D retained a 1% general partnership interest. D was authorized to issue and sell bonds in an amount not exceeding a for purposes of financing the acquisition of Property 3.

On the next day, Date 5, Owner purchased Property 4. The details surrounding the purchase of Property 4 are not clear; however, there is evidence that Owner transferred Property 4 to a limited liability corporation several years after the period in dispute.

On Date 6, the day before the expiration date of the 180 day period for the receipt of replacement property, Owner and C entered into an agreement with F for the purchase of Property 3. Owner purchased the land and C purchased the improvements. Also on Date 5, Owner executed an exchange agreement with Qualified Intermediary by which Qualified Intermediary agreed to acquire Property 4, the land component of Property 3 and Owner's partnership interest in C. Qualified Intermediary agreed to transfer the acquired property to Taxpayer.

On its income tax return for Year 6, Taxpayer reported the disposition of Property 1 as a sale and the disposition of Property 2 as a like-kind exchange. For purposes of Taxpayer=s computations, Property 4 and the land component of Property 3 were considered properties of a like kind to Property 2.

Later, Taxpayer filed an administrative adjustment request, requesting permission to change the way the sales of Property 1 and Property 2 were reported. In the administrative adjustment request, Taxpayer claimed that the disposition of Property 1 and Property 2 resulted in cancellation of indebtedness income and an overall loss on the sale of Property 2.

LAW AND ANALYSIS

Section 1031(a)(1) provides generally that no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such 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.

Section 1031(a)(2)(D) provides that section 1031(a) is not applicable to any exchange of interests in a partnership. This exception is applicable to all transfers made after July 18, 1984 in tax years ending after that date. For these purposes, an interest in a partnership which has in effect a valid election under section 761(a) to be excluded from the application of all of subchapter K is treated as an interest in each of the assets of such partnership and not as an interest in a partnership.

Section 761(a) provides that, under regulations, the Commissioner may, at the election of all the members of an unincorporated organization and if the income of the members of the organization may be adequately determined without the computation of partnership taxable income, exclude the organization from the application of all or part of Subchapter K, if the organization is availed of:

1. for investment purposes only and not for the active conduct of a business;

2. for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted; or

3. by dealers in securities for a short period for the purpose of underwriting selling or distributing a particular issue of securities.

Treas. Reg. ' 1.1031(k)-1 provides rules for treatment of deferred exchanges. A deferred exchange is defined as an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the Arelinquished property@) and subsequently receives property to be held either for productive use in a trade or business or for investment (the Areplacement property@).

Section 1031(a)(3)(A) provides that replacement property shall not be treated as like-kind property if it is not identified as replacement property on or before the 45th day after the transfer of the property relinquished in the exchange.

Section 1031(a)(3)(B) provides that replacement property shall not be treated as like-kind property if it is not received on or before the 180th day after the transfer of the relinquished property, or, if this date is earlier, on the due date of the tax return for the taxable year in which the transfer of the relinquished property occurs.

Treas. Reg. ' 1.1031(k)-1(c)(2) provides that replacement property is identified only if it is designated as replacement property in a written document signed by the taxpayer and sent before the end of the identification period to either the person obligated to transfer the replacement property to the taxpayer or any other person involved in the exchange who is not disqualified.

Treas. Reg. ' 1.1031(k)-1(c)(4) allows a taxpayer to identify more than one replacement property. A taxpayer may identify a maximum of 3 replacement properties without regard to the fair market values of the properties. However, a taxpayer is allowed to name any number or properties as replacement properties as long as their aggregate fair market value as of the end of the identification period does not exceed 200% of the aggregate fair market value of all the relinquished properties as of the date of the transfer of the relinquished properties.

Treas. Reg. ' 1.1031(k)-1(g) provides for various safe harbors for deferred exchanges which result in a determination that the taxpayer is not in actual or constructive receipt of money or other property (not of like kind) for purposes of section 1031(a). One of the safe harbors listed in paragraph (g) is that of the qualified intermediary.

Treas. Reg. ' 1.1031(k)-1(g)(4)(i) provides that in the case of a taxpayer=s transfer of relinquished property involving a qualified intermediary the qualified intermediary is not considered an agent of the taxpayer for purposes of section 1031(a). In such a case, the taxpayer=s transfer of relinquished property and subsequent receipt of like-kind replacement property is treated as an exchange. This provision applies only if the agreement between the taxpayer and the qualified intermediary expressly limits the taxpayer=s rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary; however, the agreement may provide that if the taxpayer has not identified replacement property by the end of the identification period, the taxpayer may have the right to receive, pledge, borrow, or otherwise obtain the benefits of money or other property at any time after the end of the identification period.

Treas. Reg. ' 1.1031(k)-1(g)(4)(iii) defines a qualified intermediary as a person who is not the taxpayer or a disqualified person and who enters into a written agreement with the taxpayer to acquire the relinquished property from the taxpayer, transfer the relinquished property, acquire the replacement property and transfer the replacement property to the taxpayer.

Issue 1

In the instant case, the transaction in dispute occurred in Year 6, well after the effective date for section 1031(a)(2)(D). Thus, if the transaction between Taxpayer and A was in fact an exchange of Taxpayer=s partnership interest in X, rather than an exchange of Taxpayer=s interest in X=s assets, the transaction would not be subject to the nonrecognition provisions of section 1031(a)(1). After reviewing this transaction, we agree with your conclusion that exchange in this case was, in substance, a transfer of Taxpayer=s partnership interest.

AThe incidence of taxation depends upon the substance of a transaction.@ Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945). In Court Holding, the taxpayer was a closely-held corporation organized to buy and hold an apartment building. During the period between October 1939 and February 1940, while the taxpayer still held title to the apartment building, negotiations for the sale of the building took place. An oral agreement was reached as to the terms of sale and a $1,000 deposit was paid. However, the taxpayer backed out of the deal when it was advised that the sale would result in a heavy tax burden. Instead, the taxpayer declared a liquidating dividend, which involved the complete liquidation of its assets and the surrender of all outstanding stock. The two shareholders surrendered their stock in exchange for the deed to the apartment building. They then entered into a sales contract that contained the same terms and conditions that the taxpayer had previously agreed upon. The only difference was that the contract named the shareholders individually as the sellers. When the sale was completed, the deposit that had been paid to the taxpayer was applied to the purchase price.

The Commissioner argued that the gain from the sale of the building should be attributed to the taxpayer based on a substance over form theory. The declaration of the liquidating dividend and the transfer of title to the apartment building to the shareholders were mere formalities designed solely to alter the tax consequences of the transaction. The Supreme Court agreed:

> The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. . . . To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

Id.

However, in United States v. Cumberland Public Service Co., 338 U.S. 451 (1950), the Court upheld a finding by the Court of Claims that a similar transaction was in fact a distribution in kind to the shareholders followed by a sale by the shareholders. In Cumberland, the taxpayer was in the business of generating and distributing electric power. A competitor began selling power in the same area and eventually it became clear that the taxpayer could not compete. Consequently, the taxpayer's shareholders offered to sell all their stock to the competitor. The competitor refused to buy the stock, but made a counteroffer to buy the taxpayer's transmission and distribution equipment. The taxpayer rejected the offer because of the tax consequences. At this point, the shareholders, who also were interested in avoiding heavy corporate capital gains tax, offered to acquire the equipment from the taxpayer and then sell the equipment to the competitor. The competitor accepted this offer. Accordingly, the equipment was transferred to the shareholders, the remaining assets were sold and the corporation was liquidated. The shareholders then sold the equipment to the competitor.

As in Court Holding, the Commissioner made a substance-over-form argument. The Commissioner argued that the shareholders had been used as a mere conduit for effecting what was really a corporate sale of the equipment. The Court of Claims disagreed, concluding the form of the transaction reflected the substance. The court also found that the taxpayer never intended to complete the sale itself and that the liquidation genuinely ended the corporation's existence.

The Supreme Court upheld the findings of the Court of Claims, reasoning that the question of whether a liquidation distribution was genuine or a sham was a question of fact better determined by the trial tribunal. Although the Court acknowledged the fact that a major motive of the shareholders was to reduce taxes, the Court made clear that this did not preclude a finding that the transaction was genuine. The Court viewed motive as one relevant factor in the determination of whether the transaction was real or a sham.

In Crenshaw v. United States, 450 F.2d 472 (5th Cir. 1971), the taxpayer was the executrix of her husband=s estate. She also owned an undivided 50/255 interest in Pine Forest Associates partnership. The partnership owned the Pine Forest Apartments. The remaining shares of the partnership were owned by Mr. and Mrs. Blair. In 1962, the Blairs approached the taxpayer with an offer to purchase her interest in the partnership. She agreed, but wanted to set up the transaction as a like-kind exchange. However, the Blairs did not own any suitable property to exchange. Accordingly, the parties agreed to the following sequence of events:

1. The taxpayer withdrew from the partnership in exchange for an undivided 50/255 interest in the Pine Forest Apartments;

2. The taxpayer exchanged her interest in the Pine Forest Apartments for other real property owned by her husband=s estate;

3. As executrix of her husband=s estate, the taxpayer transferred the estate=s interest in the Pine Forest Apartments to a newly formed corporation owned by the Blairs. In exchange the estate received $200,000 in cash; and

4. The Blair=s corporation transferred the 50/255 interest in the Pine Forest Apartments to the partnership in exchange for the undivided 50/255 interest in the partnership formerly owned by the taxpayer.

The issue was whether there was a taxable sale of the taxpayer=s partnership interest for $200,000 or whether there was a tax-free liquidation of the taxpayer=s partnership interest followed by a like-kind exchange of property.

Relying on the substance-over-form doctrine, the court disregarded the transfer of the interest in Pine Forest Apartments to the taxpayer and concluded that the series of transfers resulted in a sale by the taxpayer of her interest in the partnership. Id. at 475. As in Court Holding, the court reasoned that the tax consequences of an interrelated series of transactions could not be determined by viewing each in isolation. Instead, the transactions had to be considered together as component parts of an overall plan. Id.

The court found the last step in the series of transactions key to its finding that a sale rather than a liquidation had occurred. The fact that the taxpayer=s 55/255 interest in the Pine Forest Apartments ultimately found its way back into the partnership in exchange for the partnership interest formerly owned by the taxpayer precluded a finding that the taxpayer=s interest in the partnership was liquidated. Id. at 476.

In Chase v. Commissioner, 92 T.C. 874 (1989), taxpayer-husband formed a limited partnership, JMI, to purchase and operate the John Muir Apartments. Taxpayer-husband held an interest in the partnership as both a general and a limited partner. The apartments were purchased in 1978. Later, Triton Financial Corp., a corporation in which taxpayer-husband held a substantial interest, was added as a general partner. The two general partners, taxpayer-husband and Triton, had the exclusive right to manage JMI. Under the partnership agreement, the limited partners were prohibited from receiving distributions of property other than cash from JMI in liquidation of their partnership interests.

In 1980, JMI accepted an offer from an unrelated individual to purchase the apartments. Taxpayer-husband wanted to structure the transaction as a like-kind exchange. To accomplish this, in January 1980 taxpayer-husband caused JMI to deed him an undivided 46% interest in the apartments. This purported to represent the liquidation of his limited partnership interest in JMI.

The first offer fell through because of delays in depositing funds into escrow. However, on March 21, 1980, JMI received a second offer for the purchase of the apartments. The buyer's letter of intent did not reflect any knowledge of taxpayer-husband's interest in the apartments. In addition, taxpayer-husband signed the escrow agreement on behalf of the partnership but not in his capacity as an individual.

In anticipation of the sale of the apartments, taxpayer-husband and the buyer entered into an exchange agreement with an intermediary. The intermediary was to receive the proceeds of the sale until replacement property could be found. Taxpayer-husband did not record the deed from JMI reflecting his 46% interest in the apartments until June 1980, just prior to closing. When the proceeds from the sale were distributed to the intermediary, the amount reflected an allocation to taxpayer-husband in accordance with his distributive share of the total net proceeds as a limited partner, not as a straight allocation of 46% of the net proceeds. In addition, the record reflected that from January 1980 until July 1980, taxpayer-husband had not paid any of the expenses attributable to the operation and sale of the apartments, nor had he received any of the rental income.

In July 1982 three replacement properties were acquired. The properties were transferred to taxpayer-husband in October 1982 to complete the exchange. Two of the properties were disposed of on the day they were acquired by taxpayer-husband. The third property was held for seven months and then sold.

One of the disputed issues was whether taxpayer-husband was entitled to nonrecognition of gain under section 1031. The Commissioner argued that section 1031(a) was not applicable because the disposition of the apartments was, in substance, a sale by JMI and not an exchange of like-kind property by taxpayer-husband.

The Tax Court agreed and held that the substance over form doctrine applied. Id. at 881. According to the court, the facts did not demonstrate that the deed conveying the 46% interest in the apartments to taxpayer-husband was respected since taxpayer-husband did not act as an owner except in his capacity as a partner of JMI. Taxpayer-husband did not record the deed until a sale was imminent, he did not pay his share of expenses and he did not demand rental income. Based on these facts the court concluded that taxpayer-husband was not a direct owner of the apartments for purposes of engaging in an exchange under section 1031. Id. at 882. The court also found the partnership had failed to satisfy the requirements of section 1031 because the partnership had not received like-kind property in the exchange. Id. at 883.

In Kinney v. United States, 228 F. Supp. 656 (W.D. La. 1964), aff=d, 358 F.2d 738 (5th Cir. 1966), the primary issue was whether the taxpayers had suffered a ordinary or capital loss. The loss was generated by taxpayer-husband=s sale of his interest in a partnership.

Taxpayer-husband and Edward Stine operated a partnership. Disagreements arose and the partners began discussing the possibility of terminating the partnership. Stine, however, did not want to terminate the business. Instead, he wanted to buy out taxpayer-husband and operate the business on his own. Negotiations took place over several months, but the parties could not reach an agreement. Taxpayer-husband was concerned with the possibility of being obligated on new business and gave notice that he wanted to terminate the partnership as of June 30, 1958. However, taxpayer-husband remained interested in selling his interest in the partnership and negotiations continued. Finally, the parties were able to reach the following agreement: 1. the fixed assets of the partnership were transferred to a newly-formed corporation in exchange for all of the stock of the corporation which would be distributed equally between taxpayer-husband and Stine; 2. the partnership was dissolved; 3. Stine received an option to purchase taxpayer-husband=s stock for a certain sum; and 3. in exchange for taxpayer-husband=s remaining interest in the partnership, Stine canceled certain partnership obligations owed by the partners, assumed all partnership liabilities and paid taxpayer-husband an additional agreed upon sum. The deal was consummated and on July 31, 1958, Stine exercised his option and purchased taxpayer-husband=s stock.

The characterization of the taxpayers= loss depended on whether a partnership interest was sold, in which case the loss would be a capital loss, or whether the transaction could be viewed as a distribution of assets from the partnership and a subsequent sale by taxpayer-husband to Stine. In the latter case, the property would retain its character as a capital or ordinary item in accordance with the way it was held by the partnership.

The court concluded that, in substance, taxpayer-husband sold his interest in the partnership rather than the assets received in a distribution. A key factor in this determination was the fact that Stine continued to operate the business formerly conducted by the partnership. Despite the formalities set up by the parties, there was no termination of the business operations of the partnership and, in the court=s view, no dissolution of the partnership. Instead, the court was persuaded that Athe substance of what occurred was a sale by the taxpayer of his entire interest in the partnership to his partner. Id. at 663.

All of the cases discussed above were decided before section 1031(a)(2) was amended to exclude from nonrecognition treatment exchanges of interests in a partnership. Accordingly, the existing authority focuses on determining the proper party to the exchange and does not directly confront the issue of whether the transactions were set up to circumvent the exceptions under section 1031(a)(2). Nevertheless, these cases provide clear authority for challenging transactions which fail to reflect economic realities, or are structured for the sole purpose of reducing tax liabilities.

Although the facts of the instant case have not been fully developed, our review of the facts you have presented suggests that the exchange transaction set up by Taxpayer may have been, in reality, a sale of Taxpayer=s partnership interest in X to A. On the whole, the convoluted series of transactions and conveyances, all occurring on Date 1, is in and of itself questionable. Further, as in Crenshaw and Kinney, the ultimate result of the series of transactions on Date 1 was the disposal of Taxpayer=s interest in X, not the dissolution of X. In fact, there is nothing to suggest X=s business activities did not continue with A operating the going business. Thus, the facts support an argument that the partnership was not dissolved on Date 1 and that the assets were not distributed to the partners. Rather, the transactions, taken together, suggest the sale by Taxpayer of its interest in X to A and A=s continuation of the business.

Another factor that weighs against accepting the form of these transactions without further scrutiny is the lack of a non-tax based advantage to either of the parties in the chosen structure of the transaction. Unlike the case in Cumberland, A did not decline Taxpayer=s offer to sell its interest in the partnership. A was not reluctant to assume additional liabilities by purchasing the partnership interest, as demonstrated by A=s assumption of Taxpayer=s liabilities. Thus, taxpayer has failed to show any economic benefit in setting up the exchange in this manner that would offset the obvious tax motivations. We therefore agree with your conclusion that it is appropriate to challenge the attempted transfer to Taxpayer of its interest in X=s assets under a substance-over-form theory.

With respect to the issue of whether the exception under section 1031(a)(2)(D) applies, we understand that Taxpayer attempted to make an election under section 761 which was received on Date 2, but which purported to be effective as of January 1, Year 5. Such an election, if effective for Year 6, would cause Taxpayer's interest in X to be treated as an interest in each of X's assets. Thus, assuming Taxpayer's disposal of its interest in Property 2 otherwise qualified under section 1031, the interest would be eligible for like-kind treatment under section 1031(a).

As a general matter, Treas. Reg. § 1.761-2(b), which covers the rules for making a valid election for exclusion under section 761, requires a statement attached to or incorporated in a properly executed partnership return. The statement should be filed along with the return not later than the proper due date for the return, as prescribed in the regulations under section 6031 and taking into account extensions, for the first taxable year for which exclusion from subchapter K is desired.

The facts surrounding the form of the election are unclear; however, we understand that it may have been submitted along with X's final partnership return and that X apparently claims it is entitled to make the election as an investment partnership. We agree that it appears that X was availed of for the active conduct of a business. Accordingly, there is a question as to whether X qualifies for exclusion from subchapter K under section 761(a)(1) at all. In addition, although it was not filed until June of Year 6, the election purported to cover calendar Year 5. Thus, there is a question as to the timeliness of the filing. Further, it is unclear to us whether such an election may be filed with a final return. As a final matter, Treas. Reg. § 1.761-2(b)(2) sets out detailed rules as to the proper method of making this election. The election in the instant case should be reviewed carefully to insure compliance with the regulations. Questions about these matters should be addressed to the Passthroughs & Special Industries Branch.

In any event, we believe that the belated attempt at making a section 761 election should be considered in connection with the substance-over-form argument as well as separately. The fact that the election was made after the purported dissolution of the partnership suggests, at a minimum, that Taxpayer was unsure of its direct ownership of the partnership property via the deeds.

<u>Issue 2</u>

Generally, section 61(a) defines gross income as "all income from whatever source derived." Included in gross income are gains derived from dealings in property, under section 61(a)(3), and income from the discharge of indebtedness, under section 61(a)(12). Section 1001(a) governs the computation of gains derived from dealings in property and provides that gain shall be the excess of the amount realized from a sale or other disposition of property over the adjusted basis in the property. Treas. Reg. § 1.1001-2(b) provides that the amount realized from the sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition. When an interest in property is transferred in exchange for an assumption or discharge of liabilities, the assumed liabilities are included in the amount realized as if the money had been paid to the seller and then paid over to the creditor. Commissioner v. Tufts, 461 U.S. 300, 306 (1983); Crane v. Commissioner, 331 U.S. 1, 13 (1947). This is also true when a taxpayer agrees to surrender property in exchange for cancellation of debt in a foreclosure sale or in a transfer in lieu of foreclosure. 2925 Briarpark, Ltd. v. Commissioner, 163 F.3d 313, 318 (5th Cir. 1999).

When a debt is forgiven, gross income includes the income from the discharge of the debt. This is based on the rationale that a reduction in debt without a corresponding reduction in assets causes an economic gain and income to the debtor because the assets are no longer encumbered. United States v. Kirby Lumber Co., 284 U.S. 1 (1931). Cancellation of indebtedness produces income to the debtor in an amount equal to the difference between the amount due on the obligation and the amount paid for the discharge. The determination of whether income is produced through cancellation of debt, or through the sale of property in exchange for an assumption of debt, is not always clear. However, as a general matter, courts have tended to interpret the term Asale or exchange@ broadly and the term Adischarge of indebtedness@ narrowly. Slavin v. Commissioner, T.C. Memo. 1989-221, rev=d in part on other grounds, 932 F.2d 598 (7th Cir. 1991). Further, it is well established that when a debt is discharged or reduced as a result of the debtor=s transfer of property to his creditor or a third party, the transaction is treated as a sale or exchange of property subject to the recognition provisions of section 1001. Danenberg v. Commissioner, 73 T.C. 370, 380-381 (1979), acq. 1980-1 C.B. 1.

We agree with your conclusion that the facts of this case do not support the argument that debt was forgiven. The provisions in the agreements between Taxpayer and A make it clear that to the extent Taxpayer was released from debt, it was in exchange for Taxpayer=s interest in property. Under these circumstances the debt that was discharged or assumed would be considered paid rather than forgiven. However, if the debt was recourse and the fair market value of the property transferred was less than the amount of debt discharged, the transaction would give rise to COD income in an amount equal to the excess of the amount of debt discharged over the fair market value of the transferred property . See Example 8, Treas. Reg. ' 1.1001-2(c).

Issue 3

As we have indicated, we have concluded that Taxpayer sold its interest in X rather than its interest in X=s individual assets. Accordingly, the exchanged property was ineligible for like-kind exchange treatment under section 1031(a)(2)(D). However, you have asked for comment on the issue of whether the transaction would otherwise qualify as a nonsimultaneous like-kind exchange assuming Taxpayer=s interest in X is treated as an interest in X=s assets.

For property to be treated as like-kind property in a nonsimultaneous exchange, section 1031(a)(3) requires that replacement property be identified on or before the 45th day after the date on which the taxpayer transfers the property relinquished in the exchange. I.R.C. ' 1031(a)(3)(A). In addition, the replacement property must be received no later than the earlier of the 180th day after the date on which the taxpayer transfers the property relinquished in the exchange, or the due date, determined taking into account extensions, for the taxpayer=s return of tax for the year the taxpayer transfers the relinquished property. I.R.C. ' 1031(a)(3)(B).

Treas. Reg. ' 1.1031(k)-1(b) and (c) provide specific rules for the identification of replacement property. These rules are mandatory for transfers of property made on or after June 10, 1991. <u>Dobrich v. Commissioner</u>, T.C. Memo. 1997-477. Under Treas. Reg. ' 1.1031(k)-1(b)(1), replacement property will not be treated as like-kind to the relinquished property if: 1. it is not identified before the end of the identification period; or 2. the identified replacement property is not received before the end of the exchange period.

A taxpayer may identify more than one replacement property; however the maximum number of properties that the taxpayer may identify without regard to the fair market values of the properties is three. Treas. Reg. ' 1.1031(k)-1(c)(4)(A). If the taxpayer identifies more than three properties, their aggregate fair market value as of the end of the identification period cannot exceed 200% of the aggregate fair market value of all of the relinquished properties as of the date the relinquished properties were transferred. Replacement property must be designated in a written document signed by the taxpayer and hand delivered, mailed, telecopied or otherwise sent before the end of the identification period to the person obligated to transfer the replacement property to the taxpayer. Treas. Reg. ' 1.1031(k)-1(c)(2).

It is our understanding that Taxpayer failed to identify any replacement property in connection with the exchange of Property 1. Accordingly, the exchange of Property 1 does not qualify as a nonsimultaneous like-kind exchange. With respect to the exchange of Property 2, your memorandum indicates that Taxpayer identified three properties as potential replacement properties for Property 2. Because Taxpayer identified only three properties, we need not consider how the fair market values of the properties related to the relinquished property.

Only one of the three identified properties, Property 4, was actually acquired by Qualified Intermediary and transferred to Taxpayer in connection with the exchange. However, we understand that Taxpayer has treated one other property that was not properly identified as like-kind property when it computed its gain from the exchange. The other property was received by Taxpayer on Date 6, well after the identification period lapsed.

You have indicated that Taxpayer takes the position that its failure to properly identify replacement property is not fatal to the issue of whether the property qualifies as like-kind replacement property in a deferred exchange. Taxpayer is mistaken on this point. Unidentified property only qualifies as replacement property if it is received by the taxpayer before the end of the identification period. Treas. Reg. ' 1.1031(k)-1(c)(1). Essentially the property is deemed identified by virtue of the transfer. However, in this case Taxpayer did not receive the unidentified property before the end of the identification period. Accordingly, the unidentified property should not be treated as like-kind to Property 2.

Assuming it is determined the other elements of the exchange were proper, i.e. the qualified intermediary was not a disqualified party, the exchange agreement complied with regulation requirements and the property was actually transferred, the only property that would qualify as like-kind property to Property 2 is Property 4. To the extent other properties were exchanged, the exchange was not solely for property of a like kind and the nonrecognition treatment provided by section 1031(a) would not apply to nonqualifying property. Treas. Reg. ' 1.1031(a)-1(a)(2).

Because we have concluded that, at best, this transaction involves the exchange of a single property for another, it is unnecessary to consider the rules concerning multiple-property exchanges. The tax consequences of the transfer of the other property should be determined outside the parameters of the like-kind exchange rules. As to Property 4, we understand that there is a factual question as to whether Property 4 was ever actually transferred to Taxpayer. Obviously, this point must be verified before any conclusions are reached on Taxpayer=s entitlement to nonrecognition treatment under section 1031(a).

With respect to your comments concerning the interaction of section 752 with section 1031, we note that Taxpayer=s eligibility to participate in a like-kind exchange presupposes that Taxpayer transferred its interest in Property 2 to A, rather than transferring its interest in X to A. If Taxpayer is deemed to have transferred its interest in Property 2, then either the section 761 election, or the transfer of X=s assets to Taxpayer and A and the dissolution of X was effective. If the transfer of assets was effective and X was dissolved, it follows that it could not assume Taxpayer=s liabilities. Thus, section 752 would not apply to the transfer of Property 2 to A. If the section 761 election was valid, then the rules of subchapter K would no longer apply to X. In any event, as you have pointed out, the facts in this case indicate Taxpayer sold an interest to A and that A assumed or canceled Taxpayer=s liabilities. There does not appear to be any evidence that X assumed Taxpayer=s liabilities in connection with the transfer of property and the argument is not consistent with our position on the COD issue. Accordingly, the transaction does not appear to fall within the parameters of section 752.

With respect to your tentative conclusions as to the applicability of section 752 to Owner and C in connection with the transfer of the land component of Property 3 and Owner=s partnership interest in C, the issue was coordinated with CC:DOM:FS:P&SI. They indicated that you properly analyzed how the partnership liability rules apply.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Whether the form of this transaction should be respected is a factual issue subject to the interpretive whims of the court. See Bolker v. Commissioner, 81 T.C. 782 (1983), aff=d, 760 F.2d 1039 (9th Cir. 1985); Mason v. Commissioner, T.C. Memo. 1988-273, aff=d, 880 F.2d 420 (11th Cir. 1989). While we believe this case supports a substance-over-form argument, we acknowledge that there are always hazards in making such an argument. In addition, we recognize that there is no authority directly on point because the relevant case law precedes the amendment to section 1031 excepting interests in partnerships from section 1031(a) treatment.

Obviously, all facts surrounding the disposition of Taxpayer=s interest in X should be considered. In Chase, 92 T.C. 874, the taxpayer allegedly received property from a partnership in his capacity as a limited partner. The taxpayer disposed of the property and set the transaction up as a like-kind exchange. However, the Commissioner was able to show that the partnership agreement did not allow a limited partner to receive property other than cash in return for his contribution. In addition, the facts were inconsistent with the taxpayer=s theory that he enjoyed a direct ownership interest in the partnership=s property. These facts helped persuade the Court that, in substance, the partnership rather than the taxpayer disposed of the property.

In this case, as a starting point, we recommend close examination of the partnership agreement between Taxpayer and A to see if it contains provisions limiting the Taxpayer=s ability to transfer its interest or to receive property from the partnership. Also, for purposes of establishing the validity of the attempted election under 761(a), you should consider whether the parties have reserved the right separately to take or dispose of their shares of any property. In addition, you should consider whether there are substantive economic benefits, other than tax benefits associated with the deferral of gain, that result from the termination of X. On this issue we note that in Bolker, 81 T.C. 782, the fact that the taxpayer=s motives involved tax planning did not prevent the Court from concluding that the taxpayer had exchanged in a qualified like-kind exchange where the tax planning was not solely related to benefits received from the exchange.

Assuming the exchange is not disqualified under section 1031(a)(2)(D), we agree with you that the facts concerning whether Property 4 was actually transferred to Taxpayer and whether the exchange agreement met the requirements under Treas. Reg. ' 1.1031(k)-1(g)(4) should be developed further. We do not recommend pursuit of the argument that Taxpayer did not hold the property for investment within the meaning of section 1031(a). As you have noted, this position has been rejected on several occasions. See Magneson v. Commissioner, 753 F.2d 1490 (9th Cir. 1985); Bolker, 81 T.C. at 804-805. Although we disagree with the conclusion that a taxpayer that receives property subject to a prearranged agreement to immediately transfer the property Aholds@ the property for investment, we are no longer pursuing this position in litigation in view of the negative precedent.

With respect to the cancellation of debt issue, we are unsure of the basis of Taxpayer=s position. However, we agree with your assessment that an issue as to the value of the property interest conveyed compared with the amount of debt assumed or discharged may arise. Accordingly, these facts should be developed further.

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By: ______________________________
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