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Section 1031: Like Kind Exchanges of Partnership Interests

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flexible in the distribution of its burden. Although it is rare to find an individual who enjoys paying taxes, "[t]axes are what we pay for civilized society."[137]

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SECTION 1031: LIKE KIND EXCHANGES OF PARTNERSHIP INTERESTS

INTRODUCTION

Section 1031 of the Internal Revenue Code is a nonelective provision[1] which permits the nonrecognition of gain or loss if property held for productive use in a trade or business is exchanged for property of a like kind which is to be similarly held or used.[2] Although the only two relevant cases suggest that section 1031 does apply to the exchange of partnership interests,[3] all the questions in this area have not been resolved.

There are two primary hurdles to obtaining a like kind exchange and qualifying for nonrecognition treatment of an exchange of partnership interests. The first is the potential inclusion of a partnership interest as a type of interest specifically ineligible under section 1031(a) for nonrecognition treatment. Even if this hurdle is surmounted, nonrecognition is only available if the partnership interests exchanged are held to be of a "like kind." The resolution of these two major issues may be influenced by which underlying theory of partnerships is adopted by the court – the "entity" theory or the "aggregate" theory. Since the courts tend to apply whichever theory produces the desired result, the analysis of individual situations is further clouded. Additionally, the critical determinations can be made only after determining which law – state or federal – controls the determination.

This note discusses these and related problems in detail in order to provide some clarity to the analysis of the application of section 1031 to the exchange of partnership interests. After briefly discussing the relevant statutory history and the distinction between the entity and aggregate partnership theories, this note analyzes the two cases that have dealt with

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137. Compania General de Tabacos de Filipines v. Collector of Internal Revenue, 275 U.S. 87, 100 (1927) (Holmes, J., dissenting).

1. *Compare* INT. REV. CODE OF 1954, §1031 *with* §1033.

2. Section 1031(a) provides: "No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment."

3. Estate of Meyer, Sr., 58 T.C. 311 (1972), *aff'd per curiam*, 503 F.2d 556 (1974); Miller v. United States, 1963-2 U.S.T.C. ¶9606 (S.D. Ind. 1963). *But see* 1975-2 CUM. BULL. 3, *non-acquiescing in* Estate of Meyer, Sr., 58 T.C. 311 (1972).

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the applicability of section 1031 to exchanges of partnership interests. After a critical examination of the two major hurdles to the application of 1031 to exchanges of partnership interests, the note concludes with a discussion of the tax consequences that result in a typical exchange if nonrecognition treatment is not permitted.

STATUTORY HISTORY

Section 1031 and its predecessors have been a part of the law since 1921.[4] The congressional policy underlying the enactment appears to be that it is unfair to tax an exchange where the property received is a continuation of the old investment still unliquidated.[5] While the provision may also have arisen from a concern over the administrative problems involved in the computation of gain or loss in transactions covered by the section,[6] it is doubtful that any such concern was the motivation.[7] Section 1031(b) requires recognition of gain if, in addition to the like kind property, boot is received; this necessitates valuation of the boot.[8] The valuation problem is equally prevalent in exchanges of property not of like kind in which valuation is required.[9]

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4. Revenue Act of 1921, PUB. L. No. 98, tit. II, §202(c)(1), 42 Stat. 230 (1923); INT. REV. CODE OF 1954, §1031. As early as 1918 certain types of exchanges involving taxpayers were excepted from the general rule of recognizing gain or loss. A regulation issued under the Revenue Act of 1918 provided that no gain or loss from the acquisition and subsequent disposition of property would be recognized unless there was a change in substance and not merely in form. TREAS. REG. 65 Art., 1563 (1920). *See also* 3 MERTENS, LAW OF FEDERAL INCOME TAXATION §2021 at 80 (1972 rev. ed.).

5. The Senate Committee on Finance's report on this portion of the 1921 act stated: "Section 202 (subdivision C) provides new rules for those exchanges or 'trades' in which, although a technical 'gain' may be realized under the present law, the taxpayer actually realizes no cash profit." Senate Comm. on Finance, Report on Internal Revenue Bill of 1921, S. REP. No. 275, 67th Cong., 1st Sess. (1921). *See also* H.R. REP. No. 704, 73d Cong., 2d Sess. (1939) which stated: "It was the purpose of the statute to postpone taxation until there had been a substantial change in the form of the investment."

6. *See* Century Elec. Co. v. Commissioner, 192 F.2d 155, 159, 1951-2 U.S.T.C. ¶9482, at 17,249 (8th Cir. 1951), *cert. denied*, 342 U.S. 954 (1952), in which the court states this was the reason for §1031's enactment.

7. *Cf.* Jordan Marsh Co. v. Commissioner, 269 F.2d 453, 1959-2 U.S.T.C. ¶9641 (2d Cir. 1959). The court, addressing the speculation raised in *Century Electric*, stated: "Congress was primarily concerned with the inequity, in the case of an exchange, of forcing a taxpayer to recognize a paper gain which was still tied up in a continuing investment. . . . These considerations, rather than concern for the difficulty of the administrative task of making the valuations . . . were at the root of the Congressional purpose in enacting §§112(b)(1) and (e)." *Id.* at 456, 1959-2 U.S.T.C. at 73,631.

8. INT. REV. CODE OF 1954, §1031(b) provides in pertinent part: "If an exchange would be within the provisions of subsection (a) . . . if it were not for the fact that property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property."

9. INT. REV. CODE OF 1954, §1001. *See, e.g.*, Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184, 1954-2 U.S.T.C. ¶9687 (Ct. Cl. 1954).

The predecessors of section 1031 all excluded exchanges of stock in trade or other property held primarily for sale,[10] but the original provision extended broadly to exchanges of all other types of like kind property, including stocks and bonds.[11] This large loophole[12] was closed by a 1923 amendment excluding "stocks, bonds, notes, choses in action, certificates of trust or beneficial interest or other securities or evidences of indebtedness or interest."[13] The Revenue Act of 1923 changed the language and the content slightly to what is the present section 1031(a). A Ways and Means Committee report on the reenactment of the section in 1934 described the provision as follows:

> The law has provided for 12 years that gain or loss is recognized on exchanges of property having a fair market value such as stocks, bonds, and negotiable instruments . . . but not on other exchanges of property solely for property of like kind. *In other words, profit or loss is recognized in the case of exchanges of notes or securities which are essentially like money* . . .[14]

This brief overview indicates that the original congressional intent in enacting the provision has been followed in subsequent enactments and amendments.

PARTNERSHIP LAW THEORY

The determination of the applicability of section 1031 to exchanges of partnership interests is complicated by the historical ambiguities of the statutory and common law characterizations of partnerships. The early common law regarded a partnership as an aggregate or collection of individuals[15] in which partnership activities and the legal incidents thereof were considered those of the partners, not those of the partnership as a separate entity.[16] Diametrically opposed to the aggregate or the common law theory of partnership is the entity concept first adopted by the English Law Mer-

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10. *See, e.g.*, Revenue Act of 1921, PUB. L. No. 98, tit. II, §202(c)(1) 42 Stat. 230 (1923); Revenue Act of 1928, PUB. L. No. 154, tit. I, §112(b)(1), 47 Stat 196 (1933); Revenue Act of 1938, PUB. L. No. 554, tit. I, §112(b)(1), 52 Stat. 485 (1938).

11. Revenue Act of 1921, PUB. L. No. 98, tit. II, §202(c)(1), 42 Stat. 230 (1923). *See* Girard Trust Co., 16 B.T.A. 308 (1929) (decided under the 1921 Act allowing an exchange of stock for bonds and stock).

12. A letter written January 13, 1923, from the Secretary of the Treasury to the Chairman of the Ways and Means Committee stated: "This provision of the act is being widely abused. Many brokers, investment houses, and bond houses have established exchange departments and are advertising that they will exchange securities for their customers in such a manner as to result in no taxable gain." H.R. REP. NO. 1432, 67th Cong., 4th Sess. (1923).

13. Revenue Act of 1923, PUB. L. No. 545, ch. 294, 42 Stat. 1560 (1923).

14. H.R. REP. No. 704, 73d Cong., 2d Sess. 13 (1934).

15. *Cf.* L.C. Jones Trucking Co. v. Superior Oil Co., 68 Wyo. 384, 234 P.2d 802 (1951); X-L Liquors v. Taylor, 17 N.J. 444, 111 A.2d 753 (1955).

16. J. CRANE & A. BROMBERG, CRANE AND BROMBERG ON PARTNERSHIP §3, at 18 (1968) (hereinafter cited as CRANE & BROMBERG).

chants,[17] which treats a partnership as a legal entity separate and distinct from its members.[18]

When the first committee was appointed by the Conference of Commissioners on Uniform State Laws to draft a uniform partnership act in 1902,[19] partnership law in the United States was an amalgamation of the strict common law aggregate theory and the more flexible mercantile theory.[20] Although the original charge to the committee was to draft a uniform act based on the mercantile or entity theory,[21] as the result of disagreement among members of the committee, the final draft was a compromise which rejected a straight entity approach.[22] The resulting Uniform Partnership Act, now adopted in forty-six states,[23] reflects both the entity and the aggregate concepts[24] by applying each concept to different partnership problems. However, both the Uniform Partnership Act and the Uniform Limited Partnership Act, adopted in forty eight states,[25] provide that a partnership interest is property separate and distinct from the partnership's underlying assets.[26]

PARTNERSHIP TAX TREATMENT

Although early federal income tax law taxed partnerships as entities,[27] the present law adopts neither the aggregate nor entity theory exclusively. Rather, "it adopts the criterion of the desirable result and applies whichever theory will produce that result."[28] Thus, the present law applies an aggregate or conduit approach to the taxation of income,[29] but applies an entity theory for other purposes.[30]

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17. *Id.* at 11.

18. This is consistently done in civil law jurisdictions by code or judicial usage. *Id.* at 18.

19. 6 NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, UNIFORM LAWS ANNOTATED 5 (Master Ed. 1969) (hereinafter cited as U.L.A.).

20. *See* WILLIS, WILLIS ON PARTNERSHIP TAXATION §1.03 (1971).

21. Lewis, *The Uniform Partnership Act—A Reply to Mr. Crane's Criticism,* 29 HARV. L. REV. 158, 159 (1915).

22. Jensen, *Is a Partnership Under the Uniform Partnership Act an Aggregate or an Entity?,* 16 VAND. L. REV. 377, 378 (1963). The original draftsman, Dean Ames of Harvard Law School, who favored the entity approach, died prior to the final draft. Lewis, *supra* note 21, at 159.

23. 6 U.L.A., *supra* note 19, at 5 (Cum. Supp.).

24. "The language of the Act reminds us of . . . some political platforms. There is some language which will please those who approve the aggregate theory. There is other language which will please those who approve the entity theory." E. WARREN, CORPORATE ADVANTAGES WITHOUT INCORPORATION 300 (1929).

25. 6 U.L.A., *supra* note 19, at 65 (Cum. Supp.).

26. UNIFORM PARTNERSHIP ACT, §26; UNIFORM LIMITED PARTNERSHIP ACT, §18. 6 U.L.A., *supra* note 19, at 349, 602.

27. *See* War Revenue Act of 1917, PUB. L. No. 377, ch. 63, §201, 40 Stat. 303 (1917).

28. WILLIS, *supra* note 20, at §1.03.

29. INT. REV. CODE OF 1954, §701. The conduit approach connotes the preservation of the characterization of the income of the partnership level.

30. For example, subject to certain limitations, partners and partnerships may have different taxable years. *Id.* §706(b). Also, partners may have transactions with the partnership in a non-partner capacity. *Id.* §707(a).

Particularly relevant is the modified entity approach applied to the sale or exchange of a partnership interest if section 1031 is not applicable. Congress in enacting the 1954 Code had several alternative methods of treating the sale or exchange of a partnership interest. Following the case law results based on the 1939 Code,[31] Congress could have continued to apply an entity approach by treating a partnership interest as a capital asset. Conversely, Congress could have chosen an aggregate approach which treats an individual partner as selling his share of each partnership asset, with the character of the gain being determined asset-by-asset.[32] Rather than choosing either of these extremes, however, Congress chose a modified entity approach.[33]

Section 741 treats gain or loss from the sale or exchange of a partnership as resulting from the sale or exchange of a capital asset. Section 751[34] modifies that rule by providing that amounts received that are attributable to unrealized receivables[35] of the partnership or to substantially appreciated inventory[36] items are considered amounts realized from the sale or exchange of property other than a capital asset. As a result of the broad scope of section 751, the modified entity approach approximates an asset-by-asset aggregate theory.

JUDICIAL RECOGNITION OF SECTION 1031 TREATMENT OF EXCHANGES OF PARTNERSHIP INTERESTS

The only two cases presenting the issue have held section 1031 at least potentially applicable to exchanges of partnership interests.[37] *Estate of Meyer, Jr.*[38] involved an exchange by Rollin E. Meyer, Sr. and Rollin E. Meyer, Jr.

31. Swiren v. Commissioner, 183 F.2d 656, 1950-2 U.S.T.C. §9384 (7th Cir. 1950), *cert. denied*, 340 U.S. 912 (1951); United States v. Donoho, 275 F.2d 489, 1960-1 U.S.T.C. ¶9315 (8th Cir. 1960). *But see* Bright v. United States, 113 F. Supp. 865, 1953-7 U.S.T.C. ¶9518 (E.D. Pa. 1953); Krist v. Commissioner, 231 F.2d 548, 1956-1 U.S.T.C. ¶9424 (9th Cir. 1956) (involving an exception where the partnership held installment obligations).

32. *Cf.* Williams v. McGowan, 152 F.2d 570, 1946-1 U.S.T.C. ¶9120 (2d Cir. 1945) (sale of a business conducted as a sole proprietorship).

33. Section 741 provides: "In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751 (relating to unrealized receivables and inventory items which have appreciated substantially in value)." INT. REV. CODE OF 1954, §741.

34. Section 751, commonly called the "collapsible partnership" provision, is designed to disallow the conversion of ordinary income to capital gains. Section 751's counterpart in subchapter C, §341, serves the same function for corporations with one major difference. The collapsible corporation is based on intent whereas the collapsible partnership provision applies regardless of intent. *See* INT. REV. CODE OF 1954, §341.

35. In addition to including accounts receivables for goods and services which have not previously been included in income, the term includes potential §1245 and §1250 income, farm recapture property and the gain on the sale of mining property (as defined in §617(d)(1)), which would be treated as ordinary income under §617(d)(1). INT. REV. CODE OF 1954, §751(c). *See generally*, WILLIS, *supra* note 20, at §20.02-.05.

36. The §751(d) definition of inventory is broader than simply stock in trade. It includes other non-capital assets which are not subject to §1231. *Id.* §751(d).

37. Estate of Meyer, Sr., 58 T.C. 311 (1972), *aff'd per curiam*, 503 F.2d 556 (9th Cir. 1974); Miller v. United States, 1963-2 U.S.T.C. ¶9606 (D.C. S.D. Ind. 1963).

38. 58 T.C. 311 (1972), *aff'd per curiam*, 503 F.2d 556 (9th Cir. 1974).

of their 50% interests in a California general partnership for interests in a California limited partnership. Meyer, Sr. received a 15% limited partnership interest and his son received a 20% general partnership interest, and each treated the exchanges as tax free under section 1031(a).

The Commissioner unsuccessfully contended that both exchanges were excepted from section 1031 because the interests under California law[39] were choses in action, a type of property excluded by the parenthetical clause in section 1031(a). The Tax Court, however, distinguished the cases relied on by the Commissioner because they involved the characterization of the interest of a deceased partner.[40] Addressing the broader question of whether the partnership interest fell within any of the proscribed classifications in the parenthetical language, the court stated:

> We are not dealing with trading in investment securities or similar intangibles. The transactions . . . were exchanges of proprietary (partnership) interests in one small business solely for proprietary (partnership) interests in a second small business before and after which both businesses were going concerns engaged in the same principal activity.[41]

Apparently the Tax Court, in concluding that the interests were not within the precluded classifications, applied an entity theory of partnership. By referring to interests exchanges as proprietary interests in small businesses, the court appears to be attempting to classify the interests as not being readily convertible to cash, and therefore outside the parenthetical proscription of section 1031(a).[42]

The Commissioner was successful, however, in his contention that the exchange by Meyer, Sr. of his general partnership interest for a limited partnership interest was not like kind exchange. The court pointed out several differences in the rights and liabilities of general and limited partners and stated that the "variousness of the natures of the general and the limited partnership interest is substantial enough to warrant invocation of the principle calling for strict construction of the exception to the rule that where gain is involved it will be recognized and taxed when it is realized."[43] This represents an additional application of the entity approach, although the court's qualification of the holding clouds the issue. The court initially focused on the different characteristics of general and limited partnership interests, which implied that the like kind determination is to be made at

39. The Commissioner relied on two cases which held that a deceased partner's interest was little more than the personal representative's enforceable right to an accounting and cash liquidation. Blodgett v. Silberman, 277 U.S. 1 (1928); McClennen v. Commissioner, 131 F.2d 165, 1942-2 U.S.T.C. ¶10,215 (1st Cir. 1942).

40. 58 T.C. at 313.

41. *Id.*

42. See text accompanying notes 4-14 *supra.*

43. The court listed as distinguishing features that a limited partner, unlike a general partner, is not personally liable for partnership debts, that he is entitled to priority in liquidation and that, absent an agreement to the contrary, the death of a limited partner does not work a dissolution of the limited partnership. 58 T.C. at 314.

the partnership interest level. But the court then confined its decision "to a situation where both partnerships owned the same type of underlying assets — in this case, rental real estate,"[44] a qualification which indicated that an aggregate approach is deemed appropriate in making the like kind determination.

The dissent rejected the dual entity-aggregate approach of the majority. Arguing that if the underlying assets are the crucial factor and the aggregate approach is appropriate, the dissent observed that an exchange of a general for a limited partnership interest is identical to an exchange of two general partnership interests as long as the underlying property interests are of like kind.[45] Rejecting this rationale, the dissent would apply an entity approach and find that limited and general partnership interests, while differing in quality or grade, nevertheless, are of like kind.[46] The Ninth Circuit affirmed per curiam the portion of the Tax Court's decision which disallowed nonrecognition to Meyer, Sr.'s exchange.[47] It applied an entity approach and found that a general partnership interest is of a different kind than a limited partnership interest.[48]

The only other case which deals with the application of section 1031 to exchanges of partnership interests is *Miller v. U.S.*, which succinctly held that an exchange of interests in general partnerships carrying on different types of retail businesses is an exchange of property of like kind.[49] Paraphrasing language from the legislative history of section 1031, the court stated:

> Plaintiff's additional investment in Miller's Supply Company was substantially a continuation of his investment in Miller's Tavern unliquidated and carried over to Miller's Supply Company.[50]

The court clearly applied a straight entity approach in making the like kind determination. Both partnerships held notes and inventories which, if an aggregate approach had been applied, would have been ineligible for nonrecognition under section 1031. While it could be argued that the like kind determination was made on the basis of the nature of the enterprises retail sales — this proposition finds no support in the decision or in prior case law. The court simply stated without discussion that the partnership interests were not within the parenthetically proscribed classifications.[51]

In summary, the two cases allowing partnership interests to be exchanged under section 1031 leave many questions unanswered. The remainder of this article will be devoted to an analysis of these problems.

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44. *Id.*
45. *Id.* at 315.
46. *Id.* at 316.
47. Estate of Meyer, Sr. v. Commissioner, 503 F.2d 556 (9th Cir. 1974) (per curiam).
48. *Id.*
49. 1963-2 U.S.T.C. ¶9606 (S.D. Ind. 1963). The taxpayer had exchanged a 50% interest in a tavern for a 25% partnership interest in an automobile and home supply store.
50. *Id.* at 89,453.
51. *Id.*

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QUALIFIED PROPERTY

The initial hurdle to be overcome in applying section 1031 to exchanges of partnership interests is the avoidance of the classification of the partnership interest as one of the prohibited interests enumerated in the parenthetical language of section 1031(a): stock in trade, or other property held primarily for sale, stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest. The first question is which law, state or federal, controls in making the determination. More specifically, is the state law classification of an interest as a security or other prohibited interest controlling, or do these terms have a federal definition? It is well settled that the meaning to be given language used in a federal tax statute is purely a federal question.[52] Although state law creates legal rights and interests, labels applied by state law are not binding for federal tax purposes.[53]

These principles may appear inconsistent with the Tax Court's approach in *Meyer* since the the court looked to California law to determine whether a partnership interest was a chose in action.[54] Because the phrase "chose in action" is borrowed from the common law and has no federal common law meaning,[55] however, it may be argued that Congress intended to borrow the state law meaning of the phrase.

Although some of the terms within the parenthetical proscription, such as stocks, bonds, notes, certificates of trust and evidences of indebtedness have a reasonably definite meaning, the remaining terms — certificates of beneficial interest, other securities and evidences of interest — are much more vague. The limited judicial interpretation of these interests suggests they are not to be broadly applied. In *Frederick R. Horne*,[56] the Tax Court held that a transferable membership in an organized commodity exchange was qualified property under section 1031. The court noted that "the certificates of membership are not dealt in either as commodities of trade or for investment purposes" and that "their sale is closely restricted and is subject to the approval of the governing body."[57] This supportive reasoning is similar to that of the Tax Court in *Meyer* regarding the inability of the taxpayer to readily convert the interest into cash.[58] The weakness of this analysis is apparent, however, when a comparison is made with closely-held corporate

52. This point was clearly made in Morgan v. Commissioner, 309 U.S. 78, 1940-1 U.S.T.C. ¶9210 (1940), in which the Supreme Court stated that "[i]f it is found in a given case that an interest or right created by local law was the object intended to be taxed, the federal law must prevail no matter what name is given to the interest or right by state law." *Id.* at 81, 1940-1 U.S.T.C. at 9546.

53. *See also* Commissioner v. Estate of Bosch, 387 U.S. 456, 1967-2 U.S.T.C. ¶12,491 (1967).

54. See text accompanying notes 39-40 *supra*.

55. *Cf.* Erie R.R. v. Tompkins, 304 U.S. 64 (1938).

56. 5 T.C. 250 (1945). *See also* Simon England, 1940 P-H B.T.A. Mem. ¶40,463 (deferred annuity contracts represent insurance and not evidence of debt); C.C. Wyman & Co., 8 B.T.A. 408 (1927) (allowing the tax free exchange of memberships).

57. 5 T.C. at 253.

58. See text accompanying notes 41-42 *supra*.

stock. In the close corporation context, one could have a small incorporated business and no liquidity due to the lack of a market for the stock, however, it is quite clear that section 1031 non-recognition treatment would be precluded if such stock interests were exchanges.[59] Perhaps the problem is the all-encompassing term "stock" and not the determination that a partnership interest and a membership certificate are outside the excluded classifications.

The court in *Horne* concluded that because the "revenue statutes carry no definition of the term . . . 'securities' . . . the terms must be given their ordinary meaning,"[60] then examined New York case law for the definition of a security.[61] Currently, because of the body of federal case law that has defined the term "security" as used in section 2(1) of the Securities Act of 1933,[62] it is more likely that federal rather than state law would be relied upon by a court to define "security" as used in section 1031(a).

The present case law approach to identify a security involves a determination of who retains immediate control over the essential managerial conduct of an enterprise.[63] If the "investor" retains no control, then regardless of his active involvement in the venture,[64] the courts will generally find a security is present. This test would require a case-by-case application to partnerships to determine whether a security was involved. There is no barrier, however, to classifying a limited partnership interest as a security under the securities law. Because of the passive role of a limited partner, a limited partnership interest fits squarely within the securities law definition of a security. The Securities and Exchange Commission has stated that limited partnership interests in real estate ventures will generally constitute a security under the 1933 Act.[65] In addition, many state courts have held that limited partnership certificates are securities under their Blue Sky laws.[66] This analysis suggests that partnership interests, particularly limited partnership interests, are vulnerable to classification as securities, which are proscribed interests under section 1031(a).

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59. *Cf.* Evert A. Bancker, 31 B.T.A. 14 (1934), *aff'd*, 76 F.2d 1, 1935-1 U.S.T.C. ¶9207 (5th Cir. 1935); Union Pac. R.R. Co. v. Commissioner, 69 F.2d 67 (2d Cir. 1934). This would not be the case, however, if the exchange of stock qualified under INT. REV. CODE OF 1954, §368.

60. 5 T.C. at 253.

61. *Id.*

62. 15 U.S.C. §77(b)(1)(1970).

63. *See, e.g.*, SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 485 (5th Cir. 1974); SEC v. Glen W. Turner Enterprises, Inc., 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

64. In the standard previously applied by the courts, the determination was based on whether the investor was an active participant or whether profits came solely from the efforts of others. *See* SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

65. SEC Securities Act Release No. 4877 (August 8, 1967), 32 Fed. Reg. 11705 (1967). In addition, several state Blue Sky Laws specifically include limited partnership interests in their definition of a security. *See, e.g.*, WIS. STAT. ANN. §551.02(13) (1975 Supp.); PA. STAT. ANN. tit. 70, §1-102(t) (1976 Supp.).

66. *See, e.g.*, People v. Woodson, 78 Cal. App. 2d 132, 177 P.2d 586 (1947); Conroy v. Schultz, 80 N.J. Super. 443, 194 A.2d 20 (1963). *But cf.* Brown v. Cole, 155 Tex. 624, 291 S.W.2d 704 (1956).

Assuming *arguendo* that partnership interests can avoid the proscribed classifications, the fact that the partnership assets include stocks, bonds and other proscribed assets may have an impact on this classification determination. The presence of sizable amounts of notes, accounts receivable and inventories in *Miller* was not even considered by the court.[67] Initially this appears to be contrary to the statutory intent. If, however, the common denominator of the proscribed assets is their liquidity, permitting a 1031 exchange of an interest in a partnership holding such assets is not necessarily contrary to the statutory intent. Generally, a partner has no means of liquidating the partnership assets, short of causing a dissolution of the partnership. If a going business is involved, this could result in a substantial loss which would preclude the dissolution alternative. This analysis, however, also reaches an inequitable result when compared to a like enterprise conducted as a corporation.

LIKE KIND DETERMINATION

The requirement that the exchange be for property of like kind is the statutory language which reflects the legislative intent to permit the continuation of the old investment still unliquidated. The regulations provide that "the words 'like kind' have reference to the nature or character of the property and not to its grade or quality."[68]

Again, the initial question in the analysis is whether state or federal law controls the like kind determination. Applying the Supreme Court's decision in *Morgan*, the proper analysis is to look to state law to ascertain the interests or right created thereby. The federal law is then applied to determine if the interests created under state law are of like kind within the meaning of section 1031(a).[69] This analysis appears to have been used in earlier cases ruling on the like kind question.[70] For example the Tax Court in *Midfield Oil Co.*,[71] while recognizing both interests as real property under state law, held that an oil and gas payment and an overriding oil and gas royalty were not property of like kind. This analysis would also support the Treasury's position that the exchange of a fee simple for a leasehold of a fee for less than thirty years, both interests in real property, is not an exchange of property of like kind.[72]

More recent decisions, however, appear to have focused solely on the state law classification of the interest and have created broad classes of property, such as real property and personalty, to which the like kind determination is then applied.[73] Because inconsistent results would occur if two states classified the same set of property rights differently, this more recent

67. 1963-2 U.S.T.C. ¶9606 (1963).
68. TREAS. REG. §1.1031(a)-1(b).
69. See text accompanying notes 52-53 *supra*.
70. Kay Kimbell, 41 B.T.A. 940 (1940); Midfield Oil Co., 39 B.T.A. 1154 (1939). *Cf.* Oregon Lumber Co., 20 T.C. 192 (1953).
71. 39 B.T.A. 1154 (1939).
72. TREAS. REG. §1.1031(a)-1(c)(2).
73. *See, e.g.*, Fleming v. Commissioner, 241 F.2d 78, 1957-1 U.S.T.C. ¶9363 (5th Cir.

analysis seems improper. However, the courts, with a few minor deviations,[74] appear to accept the proposition that interests in real property are of like kind. The portion of the *Meyer* decision holding that a general and a limited partnership interest are not property of like kind suggests that the courts are not taking as liberal an approach to personalty as they have to real property. The *Meyer* conclusion was reached despite the fact that both the Uniform Partnership Act and the Uniform Limited Partnership Act provide that a partner's interest in a partnership is personalty.[75]

If the courts apply an eitity approach in making the like kind determination, as was apparently the case in *Miller* and *Meyer,* the question of whether all personalty is considered like kind property is not critical. Presumably the exchange of a general for a general and a limited for a limited partnership interest would constitute exchanges of like kind property. If the courts, however, apply an aggregate theory and make the like kind determination by examining the underlying assets, the question of whether all personalty is considered like kind property could be critical since it would be an unusual situation in which both partnerships held the same type of personal property.

SUBVERSION OF SECTIONS 741 AND 751

Application of sections 741 and 751 to a hypothetical situation will demonstrate the results if section 1031 is inapplicable to an exchange of partnership interests.

Balance Sheet of the ABCD Partnership

Assets	Adjusted Basis	FMV
Cash	40,000	40,000
Accounts Receivable	-0-	40,000
Inventory	20,000	80,000
Buildings (recomputed basis 160,000)	140,000	180,000
	200,000	340,000

Capital Account	Adjusted Basis	FMV
A	50,000	85,000
B	50,000	85,000
C	50,000	85,000
D	50,000	85,000

1957), *rev. on other grounds sub nom.,* Commissioner v. P.G. Lake, Inc., 356 U.S. 260, 1958-1 U.S.T.C. ¶9428 (1958); Commissioner v. Crichton, 122 F.2d 181, 1941-2 U.S.T.C. ¶9638 (5th Cir. 1941).

74. See text accompanying notes 71-72 *supra* and note 76 *infra.*

75. UNIFORM PARTNERSHIP ACT §26; UNIFORM LIMITED PARTNERSHIP ACT §18.

Balance Sheet of the WXYZ Partnership

Assets	Adjusted Basis	FMV
Cash	20,000	20,000
Accounts Receivable	-0-	100,000
Inventory	120,000	80,000
Building	240,000	160,000
	280,000	360,000

Capital Account	Adjusted Basis	FMV
W	120,000	90,000
X	120,000	90,000
Y	120,000	90,000
Z	120,000	90,000

If *B* exchanges his interest in the ABCD Partnership for *W*'s interest in the WXYZ Partnership, sections 741 and 751 yield the following results: *B* would recognize $40,000 of gain (amount realized, $90,000, less adjusted basis, $50,000). The characterization of this would be as follows: (1) $10,000 ordinary income under section 751(c) representing *B*'s share of the accounts receivable; (2) $5,000 of ordinary income under section 751(c) representing *B*'s share of the section 1250 recapture; (3)$15,000 of ordinary income under section 751(d) representing *B*'s share of the substantially appreciated inventory; and (4) $10,000 of capital gain under section 741. Section 751(c) requires *W* to recognize $25,000 of ordinary income representing his share of the accounts receivable. To reflect that inclusion, *W*'s basis in the partnership interest is increased to $145,000. *W* now has $60,000 of capital loss (amount realized, $85,000, less adjusted basis, $145,000).

The function of sections 741 and 751 is to prevent the conversion of what would normally be ordinary income into capital gains, which would occur if one partnership had substantial section 751 property and the other primarily capital assets or section 1231 property.[76] Recapture, one specific type of section 751 property, provides a wrinkle to the above analysis in which the aggregate versus entity dichotomy is again relevant. If a straight entity theory is applied, the recapture problem is ignored. The exchanging

76. In a somewhat analogous situation, the Supreme Court in Commissioner v. P.G. Lake, Inc., 356 U.S. 260, 1958-1 U.S.T.C. ¶9428 (1958) held that an exchange did not satisfy the property of like kind requirement. The court disallowed the exchange of oil payment rights for a fee interest in a ranch, both interests in real property, stating that the assignment of the oil payment was merely an arrangement for delayed cash payment of the purchase price of the ranch. The court found no conversion of a capital asset because the oil payment when received would have constituted ordinary income to the original owner. This reasoning appears applicable to a partnership interest in a partnership with substantial §751 property. If the partner had continued to hold the original interest he would have recognized ordinary income upon the disposition or collection of the §751 property. The *P.G. Lake* decision may control this situation and require a finding that the property is not of like kind.

partners would take carryover bases in their new partnership interest[77] and would be subject to recognition of recapture if the new partnership entered into a transaction which triggered the recapture provisions. This recognition as to the new partner could be altered if the optional adjustment[78] to basis of partnership property is elected.[79] Section 743 provides the new partner with a special basis in the partnership assets which in the aggregate equals his basis in his partnership interest. Thus, if the optional adjustment were in effect, the amount of recognition to the new partner as a result of a partnership transaction which triggers recapture would reflect the adjustment. If the new partner's basis in his partnership interest were high in relation to the partnership's aggregate basis in its assets, the new partner could avoid recognition totally.

If an aggregate theory is applied in making the like kind determination, however, both section 1245 and section 1250 provide a limited exception to recapture recognition where section 1031 is applicable.[80] This exception, requires recognition to the extent of the fair market value of property received which is not section 1245 or 1250 property regardless of the fact that this non-section 1245 or 1250 property qualifies under section 1031.[81] Thus, unless there are parallel assets in both partnerships, some recapture will be required; this would be in addition to the boot required to be recognized if section 1031(b) were applicable. If either partnership held property with substantial recapture, application of section 1245(b) could defeat the nonrecognition exchange. Additionally, the question of the carryover taint provided by the regulation still remains.[82] Although one commentator has suggested that the taint might attach to the partnership interest itself and the recapture provision triggered by a subsequent disposition,[83] this approach has no statutory basis and appears clearly erroneous. Since there is no method for providing for the carryover taint, the exceptions to sections 1245 and 1250 do not appear to be available in this situation.

EFFECT OF THE ASSUMPTION OF PARTNERSHIP LIABILITIES

An additional problem arises on the transfer of partnership liabilities between the exchanging partners. The analysis of the problem involves section 752 and 1031(b) and (d) and assumes a straight entity approach. In order to understand the problem, it is first necessary to understand the

77. INT. REV. CODE OF 1954 §1031(d).

78. *Id.* §743.

79. In order for the optional adjustments provision to be activated it is necessary for the partnership to file an election with the Secretary as provided for in §754. *Id.* §754. Section 732(d) provides a limited exception to the partnership election requirement by allowing the partner to make the election in limited circumstances. *Id.* §732(d).

80. *Id.* §§1245(b)(4), 1250(d)(4).

81. *Id.* §§1245(b)(4)(B), 1250(d)(4).

82. TREAS. REG. §1.1245-2(c)(4). The only statutory authority for this is the parenthetical clause "whether in respect of the same or other property" found in INT. REV. CODE OF 1954, §1245(a)(2).

83. Blankenship, *After the Meyer Case: An Analysis of Tax-Free Partnership Exchanges,* 38 J. TAXATION 278, 279-80 (1973).

mechanics of how partnership liabilities[84] affect the basis of a partner's partnership interest. First, section 752(c) provides: "[A] liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property."[85] The regulations offer the following elaboration on this proposition:

> However, where none of the partners have [*sic*] any personal liability with respect to a partnership liability (as in the case of a mortgage on real estate acquired by the partnership without the assumption by the partnership or any of the partners of any liability on the mortgage) then all partners, including limited partners, shall be considered as sharing such liability under section 752(c) in the same proportion as they share the profits.[86]

Section 752 further provides that a partner's share of the liabilities of the partnership is reflected in the partner's basis in his partnership interest. Therefore, an increase or decrease in a partner's share of the partnership's liabilities is reflected by a corresponding increase or decrease in the partner's basis in his partnership interest.[87]

When the principle of *Crane v. Commissioner*[88] is applied, the partner's share of the partnership liabilities (as computed under Section 752(c)) assumed in the exchange of the partnership interests are included in determining the amount realized. The liabilities are deemed transferred directly between the exchanging partners, regardless of whether the liabilities are specifically assumed or simply taken subject to the liabilities. Section 1031(d) then treats the amount of the liabilities assumed as money received by the taxpayer; as such, the liabilities assumed constitute boot under section 1031(b). The Service has to some extent, softened this effect by following an administrative practice of permitting a "balancing of [the] liabilities when mortgaged property is exchanged for mortgaged property and each party to the exchange assumes the mortgage of the other party."[89] Despite this amelioration, the boot generated may preclude the exchange unless the liabilities of the exchanging partners are relatively equal.

84. Liabilities as used in §752 include a partnership obligation for the payment of outstanding trade accounts, notes and accrued expenses, whether or not recorded on the partnership books under its accounting method. Rev. Rul. 60-345, 1960-2 CUM. BULL. 211.

85. INT. REV. CODE OF 1954, §752(c).

86. TREAS. REG. §1.752-1(e). This principle is extremely important to limited partnerships which are structured as tax shelters.

87. INT. REV. CODE OF 1954, §§752(a) and (b).

88. 331 U.S. 1, 1947-1 U.S.T.C. ¶9217 (1947). Section 752(d) assures this result by providing: "In the case of a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships."

89. Rev. Rul. 59-229, 1959-2 CUM. BULL. 180, 182. Although the revenue ruling speaks in terms of "mortgages" and "assumed," there would appear to be no policy justification for restricting the balancing amelioration to real property or to liabilities that are assumed as opposed to those that are taken subject to.