§ 2:8 Property excluded from nonrecognition treatment—Other securities or evidence of indebtedness or interest

Securities and evidence of indebtedness or interest are excluded from nonrecognition under I.R.C. § 1031. The term "security" has no exact legal definition. It is now generally used to refer to instruments for the payment of money, or evidencing title or equity, with or without some collateral obligation, and which are commonly dealt in for the purpose of financing and investment.[1] The IRS takes the position that these exclusions under I.R.C. § 1031(a) in part encompass all types of equity interests in financial enterprises other than by direct ownership of the underlying property.[2] The old cases dealing with the exchange of partnership interests were concerned with whether such interests were securities or evidence of indebtedness or interest.[3] The definition of a security for the purposes of I.R.C. § 1031 is different from the definition of a security for the purposes of securities regulation under the Securities Act of 1933. Therefore, an interest in a tenancy in common arrangement can qualify as replacement property in an exchange even though it is a security under the Securities Act.[4]

§ 2:9 Property excluded from nonrecognition treatment—Interests in a real estate investment trust

Interests in a real estate investment trust or "REIT" do not qualify as replacement property in an I.R.C. § 1031 exchange.[1] An interest in a REIT is an entity and not an interest in real property. A REIT may be a corporation, trust or association.

Real property owners sometimes acquire interests in an "umbrella partnership real estate investment trust" or "UPREIT." The real property owner contributes the property to an "operating partnership" (OP) with the REIT as a partner. The OP may then exchange the contributed property in a 1031 exchange. Alternatively, the real property owner may exchange into replacement property and then contribute it to the OP. These types of arrangements have tax issues for the real property owner if these contributions to the OP are prearranged prior to the exchange. These tax issues are discussed in Chapter 9, regarding contributions to partnerships. These arrangements are also subject to complex partnership tax rules regarding debt allocation and precontribution gain. Such contributions offer an alternative to I.R.C. § 1031. A full discussion of these techniques is beyond the scope of this book.[2]

§ 2:10 Property excluded from nonrecognition treatment—Interests in partnership or limited liability company

The exclusion of interests in a partnership from nonrecognition treatment under

---

[Section 2:8]

[1]See Horne v. C. I. R., 5 T.C. 250, 1945 WL 20 (T.C. 1945).

[2]See Rev. Rul. 78-135, 1978-1 C.B. 256.

[3]Gulfstream Land and Development Corp. v. Commissioner of Internal Revenue, 71 T.C. 587, 1979 WL 3690 (1979); Estate of Meyer v. Commissioner of Internal Revenue, 58 T.C. 311, 1972 WL 2503 (1972), aff'd, 503 F.2d 556, 74-2 U.S. Tax Cas. (CCH) P 9676, 34 A.F.T.R.2d 74-5771 (9th Cir. 1974) and nonacquiescence recommended by, 1974 WL 36354 (I.R.S. AOD 1974) and nonacq., 1975-2 C.B. 1.

[4]See § 9:10.

[Section 2:9]

[1]Ltr. Rul. 8206109.

[2]See "Real Estate Investment Trusts Handbook," 2009-2010 Ed., West Securities Law Series; Ltr. Ruls. 9428018, 9340056; Grant, "Tax Planning for Umbrella Partnership REITs," 21 J of Real Est Tax'n 195 (Spring 1994).

I.R.C. § 1031 was added in 1984.[1] The legislative history of the amendment notes that prior law did not specifically state whether I.R.C. § 1031 was intended to exclude partnership interests from nonrecognition treatment. The Internal Revenue Service (IRS) had ruled that partnership interests were equity interests similar to those interests excluded under the provisions in effect before the 1984 amendment.[2] The courts which considered the issue uniformly ruled against the IRS's position where the issue concerned an exchange of interests in different general partnerships holding primarily real property.[3]

The Regulations[4] provide that the nonrecognition treatment of I.R.C. § 1031(a)(1) does not apply to any exchange of partnership interests, whether the interests exchanged are general or limited partnership interests, or are interests in the same or different partnerships. These Regulations also apply to limited liability companies that are taxed as partnerships and not as sole proprietorships.[5] A general partnership interest can be converted to a limited partnership interest, or vice versa, in the same partnership without recognition of gain under I.R.C. § 721.[6] An interest in a partnership that has in effect a valid election under I.R.C. § 761(a) to be excluded from the application of all of subchapter K is treated for purposes of I.R.C. § 1031 as an interest in each of the assets of the partnership and not as an interest in a partnership.[7] The purchase by a partner of all of the remaining interests of the other partners in the partnership may qualify as replacement property in an exchange for the purchasing partner.[8] If a taxpayer owns 100% of a disregarded LLC and the taxpayer sells a portion of the LLC interests to a buyer, the taxpayer is treated as if it first sold an undivided interest in the assets of the LLC and the taxpayer and the buyer then contributed their undivided interests to a new partnership. Therefore, the sale of the LLC interests by the taxpayer could be structured as an exchange by the taxpayer of an undivided interest in the underlying property.[9] The buyer's acquisition of a portion of the LLC interests is treated as the acquisition of an undivided interest in the underlying property followed by a contribution to the new partnership and could qualify as replacement property in an I.R.C. § 1031 exchange, but might fail the "qualified purpose" requirement discussed later in this chapter.

The problems arising from real property exchanges where partnership terminations and formations are involved are dealt with later in this work.[10] The differences between a tenancy in common and a partnership for the purposes of I.R.C. § 1031 are also discussed in Chapter 9.

[Section 2:10]

[1]Tax Reform Act of 1984, Pub L No. 98-369, 98th Cong, 2d Sess, approved July 18, 1984; I.R.C. § 1031(a)(2)(D).

[2]Rev. Rul. 78-135, 1978-1 C.B. 256.

[3]Estate of Meyer v. Commissioner of Internal Revenue, 58 T.C. 311, 1972 WL 2503 (1972), aff'd, 503 F.2d 556, 74-2 U.S. Tax Cas. (CCH) P 9676, 34 A.F.T.R.2d 74-5771 (9th Cir. 1974) and nonacquiescence recommended by, 1974 WL 36354 (I.R.S. AOD 1974) and nonacq., 1975-2 C.B. 1; Gulfstream Land and Development Corp. v. Commissioner of Internal Revenue, 71 T.C. 587, 1979 WL 3690 (1979); Long v. Commissioner of Internal Revenue, 77 T.C. 1045, 1981 WL 11341 (1981); Pappas v. Commissioner of Internal Revenue, 78 T.C. 1078, Tax Ct. Rep. (CCH) 39116, 1982 WL 11114 (1982).

[4]Reg. § 1.1031(a)-1(a)(1).

[5]See § 2:47 for a discussion of single member LLCs.

[6]Rev. Rul. 84-52, 1984-1 C.B. 157; see § 2:46.

[7]Omnibus Budget Reconciliation Act of 1990, § 11703(d), Pub L No. 101-508, 101st Cong, 2d Sess, approved Nov. 5, 1990. This treatment applied to all transfers after June 18, 1984; see § 9:10.

[8]Rev. Rul. 99-6, 1999-1 C.B. 432; see § 9:4.

[9]Rev. Rul. 99-5, 1999-1 C.B. 434.

[10]See §§ 9:1 et seq.