

# FORMATION OF A SINGLE-ASSET ENTITY COMBINED WITH AN IRC SEC. 1031 EXCHANGE

## I. INTRODUCTION

### A. Illustrating the Issues

#### 1. SINGLE ASSET ENTITY

- a. Acquiring corporation (“A Corp.”) proposes to exchange its shopping center located in Texas (“Center”) for an office building located in California (“Office”).
  - 1) A Corp. is an “S” corporation that owns 4 real estate properties.
- b. A Corp. wants the transaction to qualify as a tax-free exchange under Section 1031 of the Internal Revenue Code.
  - 1) A Corp. will assume the existing mortgage on the Office.
  - 2) The lender has agreed to the assumption, provided the Office is held in a “single-asset” entity.
    - a) The single-asset entity requirement will protect the lender against bankruptcy proceeding brought against A Corp.’s other properties.
    - b) To satisfy the lender’s requirement, A Corp. must transfer the Center and acquire Office in a separate, single-asset entity.

#### 2. ISSUES

- a. Will the transfer of the Center into a single-asset entity and then an exchange of the Center for Office qualify as a Section 1031 exchange?
  - 1) Is the transfer of property from one entity into another entity which is then immediately followed by a IRC Sec. 1031 exchange permitted?
  - 2) Is the Center “like-kind” with the Office?
  - 3) Have both properties been “held for investment?”
  - 4) What type of entity should be used and what happens if the wrong entity is selected?
- b. Does it matter if A Corp. was once a “C” corporation and had earnings and profits?

### 3. CONCLUSION

- a. Although there is no case law precedent nor IRS rulings directly on point, the transaction, if properly structured, should qualify as a Section 1031 exchange.
- b. The IRS, however, has consistently opposed Section 1031 exchange treatment for these transactions.

## II. ANALYSIS

### A. The Transfer to a Single-Asset Entity

#### 1. DO NOT DISTRIBUTE THE CENTER TO THE SHAREHOLDERS

- a. Since A Corp. is an "S" corporation, it cannot distribute the Center to its shareholders without them incurring a tax under IRC Sec. 1368(b).
  - 1) The tax will be based on the fair market value of the Center, minus the adjusted basis in the stock of the shareholders.
  - 2) A Corp. cannot transfer the property to a subsidiary without running afoul of the prohibitions against "S" corporations becoming members of an affiliated group.

#### 2. FORM A GENERAL PARTNERSHIP

- a. A Corp. should form a general partnership and contribute the Center to the partnership in exchange for a partnership interest.
  - 1) Such a transfer is tax-free under IRC Sec. 731. As discussed below, A Corp. is permitted to own an interest in a partnership.
  - 2) Also, there appears to be no prohibition against first engaging in a IRC Sec. 731 transfer to a partnership, and then following with an IRC 1031 exchange.

### B. The Exchange of Center for the Office

#### 1. THE "LIKE-KIND" REQUIREMENTS OF IRC SEC. 1031

- a. Generally, under IRC Sec. 1031, property that is held for investment may be exchanged, for like-kind property which is then held for investment.
  - 1) Both the Center and the Office qualify as like-kind property, since IRC Reg. 1031(a)-1(b) treats real estate as like-kind to other real estate, despite differences in grade or quality.

#### 2. WAS THE CENTER "HELD FOR INVESTMENT" BY THE NEW ENTITY WITHIN THE REQUIREMENTS OF IRC SEC. 1031?

- a. The contentious issue is whether property is "held for investment" when that property is first transferred from a corporation to a partnership and then is immediately exchanged.

- 1) In situations similar to the proposed transaction, the IRS has consistently argued that properties such as the Center are not held for investment purposes by the partnership; rather, they are held for the purpose of engaging in an IRC Sec. 1031 exchange.
  - a) For instance, in Revenue Ruling 75-292, the IRS concluded that an individual who first exchanged land and then transferred the land he received to a newly formed corporation did not qualify under IRC Sec. 1031, since the taxpayer had never held for investment the land he received .

### 3. THE IRS POSITION

- a. The IRS refuses to recognize the combination of IRC Sec. 1031 with another non-recognition provision.
  - 1) IRC Sec. 1031 states that property transferred in an exchange must have been held for investment and the property acquired must be held for investment.
    - a) In Revenue Ruling 75-292, 1975-2 CB 333, a taxpayer exchanged real estate used in his business for an office building and then immediately transferred the office building to a newly formed corporation in a tax-free incorporation under IRC Sec. 351.
      - (1) The IRS ruled that IRC Sec. 1031 did not apply since the taxpayer never held the office for investment; he merely acquired it to transfer to his wholly-owned corporation.
      - (2) **Note:** An IRS revenue ruling merely states its position and does not constitute legal authority. Revenue rulings are not binding on any court of law.
    - b) In Revenue Ruling 77-337, 1977-2 CB 305, a corporation liquidated (under former IRC Sec. 333) and transferred a shopping center to the corporation's sole shareholder. The shareholder then immediately exchanged the shopping center for like-kind property under IRC Sec. 1031.
      - (1) The IRS ruled that the shareholder never held the shopping center for investment; therefore, IRC Sec. 1031 did not apply.

## B. The Case Law

### 1. THE MAGNESON CASE

- a. The IRS's argument, however, was unsuccessful in Magneson v Commissioner, 753 F. 2d 1490 (9th Cir, 1985), where a taxpayer was accorded tax-free exchange treatment under IRC Sec. 1031 when he transferred property ("first property") held for investment for an undivided 10% interest in like-kind property ("second property"), and then transferred

the second property to a partnership in exchange for a general partnership interest.

- 1) The court focused on the “held for investment” requirement and concluded that the taxpayer had held the first property for investment and continued to hold the second property for investment through its general partnership interest.
  - a) The Court decided that once the transaction had been completed, the taxpayer had continued to hold like-kind property for investment, despite the transitory individual ownership of the second property.

## 2. THE BOLKER CASE

- a. In Bolker vs. Commissioner, 760 F. 2d 1039 (CA-9, 1985), A corporation liquidated under former IRC Sec. 333 and distributed real estate to its sole shareholder who then exchanged the property for like-kind real estate under IRC Sec. 1031.
  - 1) The Court held that if a taxpayer owns property that he does not intend to liquidate or use for personal pursuits, he is holding that property for investment within the meaning of IRC Sec. 1031 and the liquidation of a corporation followed by an IRC Sec. 1031 exchange is permissible.
  - 2) Although the Bolker case appears to flatly contradict the IRS’s position in Revenue Ruling 77-337, the court merely stated that the Revenue Ruling was not precisely on point.

## 3. THE MALONEY CASE

- a. The Tax Court ruled in Maloney vs. Commissioner, 93 TC 89 (1989) that an IRC Sec. 1031 exchange of property by a corporation followed by a corporate liquidation under IRC Sec. 333 was tax-free under Bolker.
  - 1) The Tax Court noted that the only difference was the order in which the steps took place and that difference did not affect the tax result.
- b. In the Maloney case, the Tax Court noted that neither an IRC Sec. 721 transfer to a partnership nor an IRC Sec. 333 liquidation was incompatible with IRC Sec. 1031.

## 4. THE CHASE CASE

- a. In Chase vs. Commissioner, 92 TC 874 (1989), the Tax Court ruled against a taxpayer who received a distribution from a partnership under IRC Sec. 721 and then immediately engaged in an IRC Sec. 1031 exchange.
  - 1) The Court found that —
    - a) The partnership had, in reality, sold the property prior to the distribution since the sale was finalized before the distribution was made to the partner;

- b) The partner had never recorded the deed showing his ownership until the sale was a certainty;
  - c) The partner never paid any of the expenses associated with ownership of the property; and
  - d) The partnership forbade the distribution of property to a partner.
- 2) The troubling part of this case is that it fits both the Bolker and Maloney transactions and should have complied with IRC Sec. 1031. Perhaps the unusual facts in Chase (described in the preceding paragraph) swayed the Court against holding that IRC Sec. 1031 applied.

### **C. Structuring the Transfer to a Single Asset Exchange with an IRC Sec. 1031 Exchange**

#### **1. MAGNESON MAY HAVE BEEN LIMITED TO GENERAL PARTNERSHIPS**

- a. The Magneson Court narrowed its decision to include only transactions involving a transfer of property to a general partnership in return for a general partnership interest, in which the property held by the general partnership is predominantly of the kind of the first property, and where the partnership's purpose is to hold the second property for investment.
  - 1) The Court found that owning a general partnership interest is similar to owning an undivided interest in land.
  - 2) The Court strongly suggested that an exchange followed by a transfer to a corporation does not meet the held-for-investment requirement, since the taxpayer exchanges the first property for shares of stock in a separate entity -- the corporation -- rather than continuing to own the property as a general partner.
  - 3) The Court distinguished the transaction in Magneson from the IRS's position under Revenue Rulings 75-292 and 77-337, stating that a transfer to a general partnership is different from the transfer to a corporation which is a distinct entity.

#### **2. USING THE MAGNESON APPROACH**

- a. In the current situation, A Corp. should follow the pattern in Magneson as closely as possible by first forming a general partnership and contributing the Center to it under IRC Sec. 731.
  - 1) A Corp. should then engage in a tax-free exchange for the Office in which the partnership will continue to hold the Office for investment.
  - 2) Although the sequence of transactions in Magneson is the reverse of the current situation, the Court's opinion regarding the held-for-investment requirement should apply to the current transaction.

- b. The IRS has not acquiesced in Magneson and still takes the position that an exchange, coupled with a prearranged transfer of the property received in the exchange, violates the held-for-investment requirement.
  - 1) A significant factor in A Corp.'s favor, however, is that the lender, for non-tax reasons, is requiring the use of a single-asset entity, and the formation of the partnership is solely for the benefit of the lender.
  - 2) A Corp. is merely seeking the tax consequences available to it on a straight Sec. 1031 exchange of Center for Office, without the imposition of a partnership.

## **D. Issues Surrounding the Formation of the Partnership**

### **1. AN "S" CORPORATION AS A PARTNER**

- a. "S" corporations are entitled to be partners in a general partnership. In Selig, 740 F.2d 572 (CA-7, 1984), an "S" corporation was a general partner in a limited partnership.
- b. The separate existence of the partnership will be respected if it conducts meaningful business activity or if there is a business purpose for its existence. Polak's Frutal Works, Inc. 21 TC 953 (1954).
  - 1) As stated above, there is a clear business reason for the partnership; therefore, it will be respected as a separate entity from A Corp.

### **2. FURTHER ISSUES**

- a. Since the partnership needs at least one other partner, should the current shareholders become general partners of the new partnership as individuals or should they form an "S" corporation, which then becomes the partner?
  - 1). Forming another "S" corporation will protect the shareholders against individual liability.
- b. If the Center has built-in gain, then its transfer in exchange for Office should not trigger an immediate tax under IRC Sec. 1374. See: Proposed IRC Reg. 1.1374-10(b).
  - 1) A subsequent disposition of the Center will be treated as if A Corp. had never transferred the Center to the Partnership.
    - a) In other words, if there is a subsequent taxable disposition of the asset, A Corp. will be taxed on the built-in gain.