Long v. Commissioner, 77 T. C. 1045 (1981)

A like-kind exchange of partnership interests qualifies under section 1031, but gain must be recognized to the extent of boot received in the form of liability relief.

Summary

Arthur and Selma Long, and Dave and Bernette Center exchanged their 50% interest in a Texas partnership, Lincoln Property, for a 50% interest in a Georgia joint venture, Venture Twenty-One. The Tax Court held that the exchange qualified as a like-kind exchange under section 1031(a), as both interests were in general partnerships. However, the court ruled that the entire gain realized on the exchange must be recognized due to the excess of liabilities relieved over liabilities assumed, treated as boot under sections 752(d) and 1031(b). The court also upheld the taxpayers' right to increase the basis of the partnership interest received by the amount of recognized gain, as per section 1031(d).

Facts

Arthur and Selma Long, and Dave and Bernette Center, residents of Georgia, were 50% partners in Lincoln Property Co. No. Five, which owned rental real estate in Atlanta. They exchanged their interest in Lincoln Property for a 50% interest in Venture Twenty-One, which also owned rental real estate in Atlanta. The exchange occurred on May 9, 1975. Prior to the exchange, both partnerships faced financial difficulties, prompting the partners to renegotiate their agreements to reallocate partnership liabilities and eliminate guaranteed payments.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the taxpayers' federal income tax for 1975 and 1976, asserting that the exchange resulted in a taxable gain. The taxpayers petitioned the Tax Court for a redetermination. The Tax Court upheld the exchange as qualifying under section 1031(a) but found that the entire gain must be recognized due to the boot received from liability relief.

Issue(s)

1. Whether the exchange of an interest in a Texas partnership for an interest in a Georgia joint venture qualifies as a like-kind exchange under section 1031(a)? 2. If the exchange qualifies under section 1031(a), whether gain should be recognized to the extent of the boot received under section 1031(b)? 3. If gain is recognized, whether the basis of the partnership interest received should be increased by the full amount of the gain recognized under section 1031(d)?

Holding

1. Yes, because both interests exchanged were in general partnerships and the

underlying assets were of a like kind. 2. Yes, because the excess of liabilities relieved over liabilities assumed constitutes boot under sections 752(d) and 1031(b), requiring full recognition of the gain realized. 3. Yes, because section 1031(d) mandates an increase in the basis of the partnership interest received by the amount of gain recognized.

Court's Reasoning

The court determined that the exchange qualified as a like-kind exchange under section 1031(a) by applying the entity approach to partnerships, as established in prior cases. The court rejected the Commissioner's arguments that the exchange was excluded from section 1031(a) due to the nature of the partnership interests or the underlying assets. The court analyzed the boot received under section 1031(b), considering the partnership liabilities under section 752. The court found that the taxpayers' attempt to reallocate liabilities close to the exchange date to reduce boot was a sham transaction and disregarded it. The court also upheld the taxpayers' right to increase their basis in the received partnership interest by the amount of recognized gain under section 1031(d), despite the Commissioner's argument against a "phantom gain" resulting from the taxpayers' negative capital account.

Practical Implications

This decision clarifies that exchanges of partnership interests can qualify as like-kind exchanges under section 1031, but gain must be recognized to the extent of boot received, particularly from liability relief. Taxpayers must carefully consider the allocation of partnership liabilities and the timing of any reallocations to avoid being deemed as entering into sham transactions aimed at reducing tax liability. The decision also reaffirms that recognized gain in such exchanges can increase the basis of the partnership interest received, potentially affecting future depreciation deductions. Practitioners should advise clients on the potential tax implications of partnership interest exchanges, including the recognition of gain and the impact on basis, and ensure that any liability reallocations have economic substance beyond tax avoidance.

