Pappas v. Commissioner, 78 T. C. 1078 (1982)

Gain from like-kind exchanges of general partnership interests is not recognized under Section 1031 of the Internal Revenue Code.

Summary

Peter Pappas exchanged his general partnership interests in two different partnerships for interests in the St. Moritz Hotel partnership. The IRS argued that these exchanges should be taxable under Section 741, which treats partnership interest sales as capital asset transactions. However, the Tax Court held that Section 1031's nonrecognition provision for like-kind exchanges applied, as the exchanges involved general partnership interests of like kind. The court also determined that Pappas did not intend to demolish the St. Moritz Hotel upon acquisition, allowing full depreciation deductions. Additionally, Pappas was liable for an addition to tax due to unreported income from a partnership interest received for services.

Facts

In January 1976, Pappas exchanged a one-third general partnership interest in Elmwood for a one-half interest in the St. Moritz Hotel partnership. In July 1976, he exchanged a one-third interest in Parkview for the remaining one-half interest in St. Moritz. Additionally, Pappas and others formed Kenosha Limited Partnership, where Pappas contributed services for a 2% general partnership interest, while others contributed the Parkview interest they received from Pappas. Pappas also acquired the St. Moritz Hotel while seeking zoning variances for a new hotel but continued operating it without demolition plans. Pappas failed to report income from a partnership interest received for services in 1976.

Procedural History

The Commissioner determined deficiencies and additions to Pappas's tax for 1973, 1976, 1977, and 1978. Pappas filed petitions with the Tax Court, which consolidated the cases. The court addressed issues related to the tax treatment of partnership interest exchanges, depreciation of the St. Moritz Hotel, and additions to tax for unreported income.

Issue(s)

1. Whether Pappas's exchanges of general partnership interests qualify for nonrecognition treatment under Section 1031.
2. Whether Pappas received "boot" in the exchanges that would require recognition of gain.
3. Whether Pappas acquired the St. Moritz Hotel with the intent to demolish it.
4. Whether Pappas is liable for additions to tax under Section 6653(a) for 1973 and 1976.

Holding

1. Yes, because the exchanges involved general partnership interests of like kind, qualifying under Section 1031.
2. No, because no boot was received except for liabilities assumed, which Pappas conceded.
3. No, because Pappas did not intend to demolish the hotel upon acquisition.
4. Yes, because Pappas failed to report income from a partnership interest received for services in 1976, resulting in additions to tax for both 1973 and 1976.

Court's Reasoning

The court applied Section 1031, which allows nonrecognition of gain for like-kind exchanges, to the general partnership interest exchanges. It rejected the IRS's argument that Section 741, which treats partnership interest sales as capital asset transactions, overrides Section 1031. The court found that the exchanges were supported by clear documentation and that the substance of the transactions aligned with their form. On the issue of intent to demolish, the court considered the factors listed in the regulations under Section 1. 165-3 and found that Pappas did not have the requisite intent when he acquired the hotel. For the unreported income, the court determined that Pappas did not meet his burden of proof in showing reliance on professional advice, thus upholding the additions to tax.

Practical Implications

This decision clarifies that Section 1031 applies to like-kind exchanges of general partnership interests, providing a significant tax planning tool for restructuring partnership interests without immediate tax consequences. Practitioners should ensure that the substance of transactions matches their form to maintain nonrecognition treatment. The ruling on intent to demolish emphasizes the need for clear evidence of intent at the time of acquisition for depreciation deductions. The case also serves as a reminder of the importance of accurately reporting income from partnership interests received for services, as failure to do so can lead to additions to tax. Subsequent cases have followed this precedent in analyzing like-kind exchanges of partnership interests.