# SPECIAL ALLOCATIONS OF GAIN BETWEEN PARTNERS IN SECTION 1031 TRANSACTIONS

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**There appears to be some basis for the position that a special allocation of gain to a withdrawing partner in a Section 1031 transaction complies with the substantial economic effect allocation rules.**

It is one of the most common difficulties faced by a partnership that owns one or more real estate investments: The time has come to dispose of an asset and some of the partners want to defer the taxable gain via a Section 1031 exchange, while other partners want their cash and are willing to pay the current tax.[1] Frequently, this results in majority partners strong-arming the dissenters into begrudgingly going along with them, or those interested in completing a 1031 exchange coming up with cash to liquidate the cash-hungry partners' interests. A frequently used alternative involves fractionalizing the ownership of the property into tenancy-in-common (TIC) interests and then conducting a part-sale and part-exchange of the property. The IRS appears to be examining the legitimacy of that strategy more closely, however, so other alternatives may become more desirable.[2]

Another option may be available, one that would minimize the need for those partners wishing to engage in a 1031 exchange to come out of pocket with cash to complete the transaction. By making special allocations of the gain on the sale of the relinquished property to the cash-hungry partners, it may be possible for the exchanging partners to complete the exchange and defer taxable gain without dividing the property into fractionalized interests.

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## A brief recap of the Section 1031 rules

To engage in a completely tax-deferred Section 1031 transaction, a taxpayer must transfer a property that has been used in a trade or business or held for investment and obtain other property to be used in a trade or business or held for investment, while meeting various other requirements, including the following:

1. The property sold ("relinquished property") must be of like kind to the property acquired ("replacement property").[3]
2. The timing requirements for identifying and acquiring the replacement property must be met,[4] as must the rules for the entity to avoid being in constructive receipt of cash for any non-simultaneous exchange.[5]
3. The total value of the replacement property must be greater than or equal to the total value of the relinquished property.[6]
4. The total equity of the entity in the replacement property must be greater than or equal to the equity of the entity in the relinquished property.[7]

In a situation in which some partners want their share of cash, and other partners want the partnership to conduct an exchange, the third or fourth requirements listed above will be violated unless the exchanging partners contribute additional cash to acquire the replacement property. This would be the result in almost all such situations because the partnership would not have enough cash to purchase a replacement property of the same value, and cannot compensate for such deficit with additional debt (which would be considered taxable "boot"). Thus, the partnership will have taxable gain under Section 1031(b) to the extent of the boot. The discussion below proposes a method to use special allocations of the gain to the cash-out partners, while minimizing the gain recognized by the remaining partners.

## Partnership taxation revisited—Special allocations and debt allocations

For gain to be specially allocated to withdrawing partners, it is vital to remember what is required for special allocations to be respected by the IRS. The watch-words are "substantial economic effect." The regulations have broken this down into two requirements: First, that the allocations have economic effect, and second, that the economic effect is substantial. More helpfully, the regulations give a safe-harbor for meeting the economic effect test. First, the partnership must be required to maintain capital accounts in accordance with Reg. 1.704-1(b)(2)(iv). Second, the partnership must liquidate in accordance with positive capital accounts.[8] Third, the partnership must require its partners to contribute to the partnership the amount of any negative capital account upon liquidation.[9] In the alternative to the third prong of this test, the partnership may have a "qualified income offset" provision in its governing document, which allows the partnership to provide for special allocations that will have economic effect without forcing the partners to contribute the amount of any negative capital account upon liquidation. A qualified income offset provision requires that for any unexpected allocation that increases a partner's deficit capital account to have economic effect, that partner must be allocated gain/income items to eliminate that increased deficit as quickly as possible.[10]

Determining whether allocations are "substantial" is more artful than determining if the allocation has economic effect. Under the regulations an allocation is not substantial if:

> (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement.[11]

**The watch-words for special allocations are 'substantial economic effect.'**

Though nebulous, the substantiality test does have some parameters that help give it shape. An allocation would be insubstantial if the capital accounts of the partners would be the same without the allocation, but the total tax liability for the partners is less than it otherwise would be without the allocation.[12] As an example, the MJ partnership (with individual partners M and J, who are equal partners) had a $25,000 capital gain and $25,000 in ordinary income from operations in year 2009. Also, M is in the highest marginal tax bracket, and J is in a lower marginal tax bracket. Any attempt to allocate all the capital gain from MJ to M, and all the ordinary income to J would lack substantiality because both would have an increase in their capital accounts of $25,000, but their total individual tax liability would be less than if they shared the capital gains and ordinary income on the standard 50-50 basis.

## The value-equals-basis rule

In the regulations regarding the substantiality test for substantial economic effect, it is stated that "for purposes of [the substantiality test], the adjusted tax basis of partnership property ... will be presumed to be the

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1 The discussion below refers only to partners and partnerships. However, most entities taxed as "partnerships" that are currently created in U.S. jurisdictions are limited liability companies that have members rather than partners under state law.

2 The 2008 Form 1065, ("U.S. Return of Partnership Income") inquires: "At any time during the tax year, did the partnership distribute to any partner a tenancy-in-common or other undivided interest in partnership property?"

3 Section 1031(a)(1).

4 Section 1031(a)(3).

5 Reg. 1.1031(k)-1(f).

6 Otherwise, the exchanger will have taxable "boot" under Section 1031(b).

7 Even if the value of the replacement property equals the value of the relinquished property, the exchange will include taxable "boot" if the equity in the property has been reduced due to increased financing.

8 Reg. 1.704-1(b)(2)(ii)(*b*)(*2*).

9 Reg. 1.704-1(b)(2)(ii)(*b*)(*3*).

10 Reg. 1.704-1(b)(2)(ii)(*d*).

11 Reg. 1.704-1(b)(2)(iii)(*a*).

**EXHIBIT 1**
***Ahlers'* Transaction Timeline**

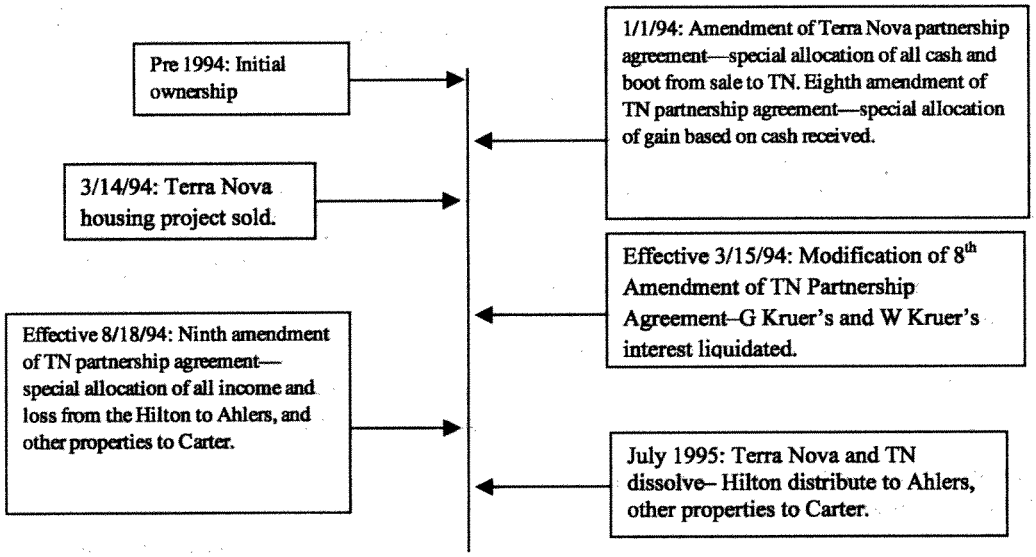



**EXHIBIT 2**
**R Partnership's Opening Balance Sheet**

| | Book Value (Basis) | Fair Market Value |
|---|---|---|
| Real Estate | $0 | $900 |
| Total Assets | $0 | $900 |
| Debt | $0 | $ 0 |
| Capital—T | $0 | $300 |
| Capital—U | $0 | $300 |
| Capital—V | $0 | $300 |
| Total Liabilities and Capital | $0 | $900 |

fair market value of such property, and adjustments to the adjusted tax basis (or book value) of such property will be presumed to be matched by corresponding changes in such property's fair market value."[13] This regulation presumes, among other things, that all depreciation taken on a property is "real," reflecting actual economic depreciation, and unrealized gains are ignored.

The question is how this rule should be read together with the substantiality requirement for partnership tax allocations—in other words, if all gain is allocated to the cash-out partner, and none to the exchanging partners, is there a "strong likelihood" that the special allocation will not cause a negative economic consequence to the exchanging partners? Arguably, the value-equals-basis regulation prevents the government from asserting that the current fair market value of a property is the appropriate measure of the real economic relationship between the partners. The theory is that the exchanging partners continue to own a property that is simply worth its cost basis or book value, and because they have not liquidated their investment it is impossible to judge whether they will ever realize economic gain from the property (as they would have if they currently cashed out from the property).[14] The examples below will attempt to make clear how this supports a special allocation having substantial economic effect.

## A review of *Ahlers*

Although the Section 1031-special allocation issue has not been addressed in any federal tax cases or rulings, the issue was discussed in a California state case that examined the state tax implications of the federal 1031 provisions in that context, *In the Matter of the*

[12] Reg. 1.704-1(b)(2)(iii)(*b*).

[13] Reg. 1.704-1(b)(2)(iii)(c). If partnership property has been revalued under Reg. 1.704-1(b)(2)(iv)(*d*), (*f*), or (*r*), the book value rather than the tax basis will be deemed the fair value.

[14] The dramatic recent drop in commercial real estate values in parts of the U.S. indicates that a continued real estate investment bears substantial valuation risk, helping justify the value-equals-basis theory. Still, in other areas of partnership tax law,

**EXHIBIT 3**
**R Partnership's Closing Balance Sheet**

| | Book Value (Basis) | Fair Market Value |
|---|---|---|
| Real Estate | $0 | $600 |
| Total Assets | $0 | $600 |
| Debt | $0 | $ 0 |
| Capital—U | $0 | $300 |
| Capital—V | $0 | $300 |
| Total Liabilities and Capital | $0 | $600 |

**EXHIBIT 4**
**W LLC Starting Balance Sheet**

| | Book Value (Basis) | Fair Market Value |
|---|---|---|
| Real Estate | $ 900,000.00 | $1,500,000.00 |
| Total Assets | $ 900,000.00 | $1,500,000.00 |
| Debt | $1,000,000.00 | $1,000,000.00 |
| Capital—X | $ 33,333.33 | $ 166,666.67 |
| Capital—Y | $ 33,333.33 | $ 166,666.67 |
| Capital—Z | $ 33,333.33 | $ 166,666.67 |
| Total Liabilities and Capital | $ 900,000.00 | $1,500,000.00 |

*Appeal of: Herman A. Ahlers and Donna M. Ahlers.*[15] The Ahlers and their partners tried to use special allocations to allow the Ahlers a partially tax deferred exchange of properties. The transaction was structured as follows: The Ahlers owned 40% of Terra Nova Associates (Terra Nova). TN Associates (TN) owned the remaining 60%. Terra Nova owned a multi-family housing project. TN was owned 62.5% by the Ahlers, 25% by Thomas Carter, 7.5% by George Kruer, and 5% by William Kruer. The parties decided that it was time to dispose of the housing project owned by Terra Nova, with both George Kruer and William Kruer looking to cash out of the partnership.

Effective 1/1/94, the Terra Nova partnership agreement was amended so that all cash and boot from the pending sale of the housing project would be allocated to TN. On 3/14/94, Terra Nova sold the housing project (through a qualified intermediary), and three replacement properties were identified: a Hilton hotel, a commercial office building ("6th & Grape"), and a 46.1538% tenant-in-common interest in an apartment building ("Escondido"). Terra Nova, on behalf of the Ahlers, purchased a 76% interest in the Hilton with the proceeds and debt allocated to the Ahlers' 40% interest in Terra Nova. TN purchased the remaining 24% interest in the Hilton, as well as the 6th & Grape building and Escondido interest with its proceeds, including the boot allocated to it from the sale of the housing project. The eighth amendment to the TN partnership

fair market value concepts are used—see e.g., Notice 2005-43, 2005-1 CB 1221; Reg. 1.704-1(b)(2)(iv)(b).

[15] Case No. 257952 before the State Board of Equalization, State of California, available on Westlaw at 2005 WL 3530147. There is also a companion case regarding other partners in the same transaction, In the Matter of the Appeal of: Thomas F. Carter and


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**EXHIBIT 5**
**W LLC Ending Balance Sheet**

| | Book Value (Basis) | Fair Market Value |
|---|---|---|
| Real Estate | $ 900,000.00 | $1,200,000.00 |
| Total Assets | $ 900,000.00 | $1,200,000.00 |
| Debt | $ 866,667.00 | $ 866,667.00 |
| Capital—X | $ 16,666.67 | $ 166,666.67 |
| Capital—Y | $ 16,666.67 | $ 166,666.67 |
| Total Liabilities and Capital | $ 900,000.00 | $1,200,000.00 |

agreement, effective 1/1/94, stated that there would be a special allocation of gain to each partner based on cash received after the transaction. By a modification to the eighth amendment effective 3/15/94, it was stated that both George Kruer's and William Kruer's interest in TN had been liquidated. The ninth amendment to the TN partnership agreement, effective 8/18/94, stated that all gains and loss of TN were to be allocated as follows: Carter should have all income and loss from the 6th & Grape building and Escondido interest, the Ahlers all income and loss from the Hilton, and all other income and loss was to be split 71.43% to Ahlers and 28.57% to Carter. In July 1995, both Terra Nova and TN dissolved, with the Hilton being distributed to the Ahlers, and the 6th & Grape building and the Escondido interest being distributed to Carter. (See Exhibit 1 on page 54.)

In reporting the transactions, the parties treated them as if two distinct 1031 exchanges had occurred. Terra Nova showed a sale with a recognized gain of $1,410,896, and a like-kind exchange of the housing project for only the Hilton, with all gain on the exchange deferred. Terra Nova also reported an exchange of the housing project for the 6th & Grape building and the Escondido interest from which a gain of $1,340,214 was realized, but only $306,909 was recognized. Terra Nova reported $1,717,805 of taxable gain on the transactions, all of which was allocated to TN, and the $378,000 in cash proceeds was distributed by Terra Nova to TN. On audit, the State of California found Terra Nova had a realized gain of $8,151,489, including $1,862,434 of cash boot and $3,128,168 of debt relief boot, for a total of $4,990,603 of boot to be recognized.

The court largely followed the state's position by disallowing the special allocation of gain to TN under the 1/1/94 amendment to the Terra Nova partnership agreement because the agreement did not require (1) proper maintenance of capital accounts or (2) liquidating distributions to be made in accordance with partners' positive capital accounts, and thus the allocations did not have substantial economic effect.[16] Therefore, the court allocated the first $378,000 of Terra Nova's gain to TN, because it actually received cash in that amount. The balance of $4,612,603 was allocated in accordance with the partners' interest in Terra Nova, so 40% (or $1,845,041) was allocated to the Ahlers and 60% (or $2,767,561) was allocated to TN.

While the court did not respect most of Terra Nova's special allocations because they lacked substantial economic effect, the court found that the TN partnership agreement did have (at least in part) substantial economic effect. Specifically, the court accepted that, to the extent any partner received cash boot from the sale of the Terra Nova housing project, that partner would be allocated gain in that amount, with all other gain to be allocated as the partners would later determine (as required by the eighth amendment to the TN partnership agreement). However, in partitioning the extra boot, the court ignored the ninth amendment to the TN partnership agreement. Instead, it allocated the extra boot among the Ahlers, Carter, William Kruer, and George Kruer based on the proportion of cash they received during the 1994 tax year, with the remaining amount allocated according to their ownership interest as stated in the eighth amendment. The court found that the ninth amendment was not an effective allocation provision because it "merely describes the partners' ownership interests in the replacement properties but there is no basis for determining the partners' interests [in the partnership]."[17]

Although the *Ahlers* court criticized drafting points in the various partnership agreements, and disallowed the majority of the purported special allocations for the simple reason that the numbers simply did not work in that case (as the total boot so dramatically exceeded the cash available), the court nevertheless did allow special allocations of gain to partners to the extent those partners actually received additional shares of cash. This gives some basis to believe that special allocations of gain in other 1031 transactions would be respected.

## Planning after *Ahlers*

The first lesson to be learned from *Ahlers* is that the entity's partnership agreement must comply with

Judith J. Carter, Case No. 258811 before the State Board of Equalization, State of California.

[16] *Id.* Importantly, because of these defects, the court's opinion goes to great lengths to show that the partners' interests in the

the requirements of the Section 704(b) regulations for substantial economic effect. If capital accounts are not properly maintained, if liquidations do not occur in accordance with positive capital accounts, or if there in not a capital account deficit-restoration provision/qualified income offset provision, the effort is likely doomed from the start. Second, the allocation of gain/boot to the withdrawing partner must be such that the cash/property distributed to the withdrawing partner upon his or her liquidation will be in accordance with his or her positive capital account. This may mean that not all gain can be allocated to the withdrawing partner.[18] Finally, by taking advantage of the value-equals-basis rule for the remaining partners, there is support that the special allocation of gain should have substantial effect because the partnership does not own an asset with a value that can be currently identified as exceeding the basis (or book value) amount. Some examples may help to clarify how this could work in practice.

**Example 1.** R partnership is owned in equal thirds by T, U, and V. R purchased real estate improvements (on leased land) for $300 in 1980, and that real estate is now worth $900. R has an adjusted basis in the property of $0, and there is no debt encumbering the real estate. T, U, and V each have a current capital account of $0 and a current adjusted basis of $0 (there are no book-tax differences between the cost basis and book value). An agreement is made to sell the real estate for $900, with T looking to cash out his interest and U and V hoping to defer taxation by a 1031 exchange. R identifies a replacement property worth $600, and will have an extra $300 in cash from the sale. Before the transaction, R's balance sheet would be as shown in Exhibit 2 on page 54.

R realizes a gain of $900 ($900 - $0), but will recognize a gain of only $300 (the amount of cash not reinvested in the replacement property). The remaining gain of $600 will be deferred. The partners agree to specially allocate the gain from the sale to T. As R's partnership agreement requires proper maintenance of capital accounts, requires liquidation in accordance with positive capital accounts, and has an unlimited deficit restoration provision, the allocation should have economic effect. Under this approach, T would be allocated the $300 of gain recognized on the transaction, increasing his capital account from $0 to $300, and then T would receive a liquidating distribution of $300 in cash. As the liquidating distribution would be identical to the amount of T's capital account, the economic effect test should be satisfied.

The bigger issue is whether the allocation is "substantial." Consistent with the value-equals-basis rule, U and V arguably have not recognized economic gains that would be sufficient to create a "strong likelihood" that U and V will not suffer economic harm from the special allocation, as they bear substantial risk with the replacement property, unlike the "cash-out" partner. (See Exhibit 3 on page 55.)

Thus, even though U and V now have 50% interests in a partnership with an asset worth $600, the IRS (and the partnership) may only presume that the economic value of that asset is zero. Thus, by specially allocating the gain to T, U and V are deemed to have forgone all current gain on the transaction, and any future gain potential (due to appreciation of, or rents derived from, replacement property) may be ignored in determining if the special allocation was substantial.[19]

Notably, in conjunction with this transaction, it appears essential for the partnership to forgo any book-up of the partnership property. The regulations permit (but do not require) a partnership's assets to be revalued at fair market value upon certain events, such as at the time of new capital contributions or liquidating distributions.[20] If the book value of the relinquished property is restated at $900, or the book value of the replacement property is restated at $600, the applicability of the value-equals-basis rule may be undercut (because after the restatement the property would be deemed to be worth its book value). Still, if no such restatement occurs, the continued legitimacy of following the value-equals-basis rule does appear to comport with the overall intent of Section 1031, which is that swapping one like-kind property for another should essentially be disregarded for tax purposes.

**In conjunction with this transaction, it appears essential for the partnership to forgo any book-up of the partnership property.**

**Example 2.** W LLC is owned in equal thirds by X, Y, and Z. W owns real estate with improvements thereon that has a current fair market value of $1.5 million and an adjusted basis of $900,000. W's property is subject to a non-recourse loan of $1 million. X, Y, and Z each has a current capital account of nega-

partnership could not be identical to the allocations they had set up.

[17] *Id.*

[18] Some commentators have questioned the feasibility of special allocations in Section 1031 exchanges because the special allocation of gain and subsequent allocation of cash may not allow for a liquidation in accordance with the withdrawing partner's capital account. See, Cuff, "Working with Some Current Challenges with Deferred Exchanges under Section 1031" (1/30/04), available at http://www.abanet.org/tax/taxiq/midyr04.html; McKee, Nelson & Whitmire, *Federal Taxation of Partnerships & Partners* (WG&L), at section 9.02[1][c][ii].

tive $33,333. The starting balance sheet would look as it appears in Exhibit 4 on page 55.

Now, X, Y, and Z determine they want to sell W's property. X and Y desire to defer the taxes on the gain, while Z prefers to be cashed out. W enters into an agreement to sell the property for $1.5 million, W identifies a replacement property for $1.2 million (purchased with $866,667 of debt and $333,333 of cash held by a qualified intermediary). The total gain recognized is equal to the $300,000 of "boot" (resulting from the decrease in value of the property by $300,000, or alternatively as a result of a failure to reinvest $166,667 of capital and due to the debt reduction of $133,333).

If there is a special allocation to Z of all of the $300,000 of gain on this transaction, the result would be as follows: Before the sale Z's capital account is negative $33,333. Upon the sale he would be allocated $300,000 of gain and his capital account would be increased from negative $33,333 to $266,667. However, because Z is entitled to a distribution of cash only equal to his value in the partnership immediately prior to the sale, he will receive only $166,667 in cash. Here, the partners have over-allocated gain to Z because the amount of cash distributed to him on liquidation is less than his capital account immediately prior to liquidation by $100,000. Since Z has been over-allocated gain without a sufficient increase in cash to compensate him, the liquidation was not in accordance with Z's capital account and thus the allocation does not comply with economic effect requirements.

Instead, Z should be allocated only so much gain as is necessary to cause his capital account to be $166,667 immediately prior to the liquidating distribution being made to him in that amount. Thus, he should be allocated $200,000 of gain. As for the remaining $100,00 of unallocated gain, that amount would be allcoated to X and Y (they could have avoided this gain if the relpacement property had avoided this gain if the replacement property had been $1.3 million, rather than $1.2 million, as boot would have been reduced by $100,000). (See Exhibit 5 on page 56.)

The remaining partners need to understand the choices to be made in these circumstances. Depending on the numbers involved, there may be an allocation of "boot" gain to them even if they do not receive cash. Further, depending on the mechanics of the deal and the amount of replacement property financing available, the remaining partners may need to come out-of-pocket with cash to satisfy the withdrawing partner. Still, in either of these cases, the use of the special allocation method reduces the total gain allocable to the exchanging members, and also would likely reduce their need to contribute new cash to facilitate the transaction.

## Conclusion

Where does all this leave an advisor? For those looking for well-established planning methods involving tax-deferred exchanges, the special allocation method discussed herein may not be the answer. However, there appears to be a basis to take the position that a special allocation of gain to a withdrawing partner in a 1031 transaction complies with the substantial economic effect allocation rules. So to those brave enough to consider this path, good luck. ■