Oregon Tax Court examines transactions utilizing Internal Revenue Code 1031/721

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In a noteworthy case entitled Marks v. Department of Revenue issued on July 24, 2007, the Oregon Tax Court was asked to interpret federal law surrounding IRCÂ§ 1031 and rule on whether an IRC Â§ 1031 exchange followed thereafter by a non-taxable (under IRC Â§ 721) contribution of the replacement property to a partnership in exchange for a general partnership interest disqualified the IRC Â§ 1031 exchange.

There are various issues raised by such a structure, but at its core it calls into question whether the exchanging taxpayer may be said to have held the replacement real property for investment or productive use in a trade or business as is required for exchange treatment or if the exchanging taxpayer was instead holding the same for contribution to a partnership and/or whether it might be said that the exchanging taxpayer never intended to acquire real estate as replacement property, but instead intended to acquire an interest in a partnership, which would not be like kind to real estate, and would be barred from exchange treatment under IRC Â§ 1031(a)(2)(D) in any event.

The resolution to these issues is relevant not only for advisors to exchanging taxpayers contemplating a contribution of replacement property to a garden variety partnership, but perhaps also for those advisors that are exploring whether there is a defensible basis on which their clients might contribute an exchange replacement property to the operating partnership of a REIT in exchange for units in that operating partnership.

The Oregon Tax Court found that IRC Â§ 1031 exchange treatment continued to be available notwithstanding the subsequent contribution to a partnership, and notwithstanding that IRC Â§ 1031(a)(2)(D) (which bars exchanges of partnership interests) was enacted after the Ninth Circuit case of Magneson v. Commissioner decided. The Oregon Tax Court found there was not, on the facts, an exchange of partnership interests and that while the form of ownership of the asset changed after the exchange, the intent investment (apparently also manifested by the investment intent of partnership), did not.

While the court's logic is not controlling federal authority, this decision seems likely to encourage similar litigation at the federal level, whether by this taxpayer if the matter is challenged in a federal audit, or by others emboldened by the logic set forth in the opinion. The period for filing an appeal in the matter has not yet run at the time of this article, and the holding is not binding federal precedent or precedent in other states, for that matter. That said, the subject matter is important enough that the case is worth following this fall to determine:

i) whether it is appealed;

ii) the outcome of any such appeal; and,

iii) (largely separate from whether or not the taxpayer prevails at the state level) whether this taxpayer (or similarly situated taxpayers) ends up litigating the fact pattern in a federal context.

Please also note that in this case the partnership interest received is that of a general partner, not a limited; and that may well be material. As always taxpayers should consult with their tax counsel and/or accountant in the first instance.

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