Agricultural Law Press
Publisher/Editor
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Issue Contents

Agricultural Law Digest

Volume 14, No. 6 March 21, 2003 ISSN 1051-2780

IS A PARTITION AN "EXCHANGE?"

— by Neil E. Harl*

In a 2002 issue of the *Agricultural Law Digest*,[1] we examined whether a partition of property involving related parties invokes the "related party" rule[2] under the like-kind exchange provision.[3] The conclusion of the article was that a partition action or a voluntary partition of property came within the exception to the related party rule for instances where the Internal Revenue Service is satisfied that avoidance of federal income tax is not a principal purpose of the transaction.[4] Specifically, there is authority indicating that transactions involving an exchange of undivided interests in different properties that result in each taxpayer holding either the entire interest in a single property or a larger undivided interest in any of the properties come within the exception to the related party rule where avoidance of federal income tax is not a principal purpose of the transaction.[5]

A 2000 *Agricultural Law Digest* article focused on the income tax consequences on the sale of property in a partition proceeding to one of the co-owners.[6] The conclusion was that such a sale does not trigger gain for the purchasing co-owner as to that co-owner's interest in the property.[7]

A closely related question is whether a partition of property is an "exchange" and whether property can be partitioned without recognition of gain or loss.[8] That question is examined in this article.

Relevant authority

The regulations state that gain or loss is realized (and recognized) from the conversion of property into cash, or from the exchange of property for other property different materially either in kind or extent, with income or loss reported.[9]

In a 1956 revenue ruling,[10] which has been cited repeatedly in subsequent private letter rulings, involving partitioning of property,[11] the conversion of a joint tenancy in the capital stock of a corporation into tenancy in common ownership of the stock (to eliminate the survivorship feature) was a non-taxable transaction for federal income tax purposes. IRS agreed with the taxpayer that the transaction was non-taxable for purposes of federal income tax.[12] Arguably, the taxpayers owned an undivided interest in the stock before the conversion to tenancy in common and owned the same undivided interest after the conversion. That makes the type of transaction involved in that revenue ruling distinguishable from a partition of property.

The Internal Revenue Service, in a 1973 revenue ruling,[13] involved three individuals who held undivided interests in three separate parcels of land owned as tenants in common. The parties agreed to partition the ownership interests. The

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Agricultural Law Digest is published by the Agricultural Law Press, P.O. Box 50703, Eugene, OR 97405 (ph 541-302-1958), bimonthly except June and December. Annual subscription $110 ($90 by e-mail). http://www.agrilawpress.com Printed with soy ink on recycled paper.

ruling holds that any gain or loss realized is not recognized and, thus, is not includible in gross income.[14] In a 2002 private letter ruling,[15] the IRS stated that the 1973 revenue ruling held that gain or loss is "realized" on a partition and did not address explicitly the question of whether the gain or loss was "recognized" although the conclusion was that the gain was not reportable into income.[16]

In a 1979 revenue ruling,[17] two unrelated owners of farmland transferred their undivided one-half interests in two parcels of farmland with each becoming the owner of a parcel. The ruling states that gain would be recognized *only to the farmland owner receiving a note in the transaction* (one parcel was subject to a mortgage and one of the taxpayers received a promissory note of one-half the amount of the outstanding mortgage on the other parcel) and then only to the extent of the fair market value of the promissory note.[18] To that extent, the transaction was considered to be an "exchange."[19] The same 2002 private letter ruling cited above[20] recited that the 1979 revenue ruling[21] reached the same conclusion as the 1973 revenue ruling,[22] namely that gain or loss is "realized" on a partition of property. The 2002 private letter ruling involved the question of whether tenancy in common property could be partitioned without recognition of gain or loss. The 2002 private letter ruling states:

> In a partition, the parties do not acquire a new or additional interest. The partition of jointly-owned property is not a sale or exchange or other disposition, merely the severance of joint ownership."[23]

While that may have been the case with the transaction in the 1956 revenue ruling[24] involving corporate stock, a partition with undivided interests transformed into the same degree of ownership in a different parcel of property seems distinguishable.

The conclusion in the private letter ruling was that no gain or loss would be "realized".[25]

In a 1993 private letter ruling,[26] the taxpayers proposed to divide real property into two parcels by partition. The ruling holds that gain or loss was not recognized in the transaction.[27]

Similarly, in a 1996 private letter ruling,[28] the partition was not considered to be a sale or exchange.[29] In the facts of that ruling, the property was contiguous and was treated as one parcel.

Conclusion

Although not entirely clear in all respects, and the authorities are not fully consistent, the bottom line seems to be that gain or loss on a partition is not *recognized* unless a debt security (such as a promissory note) is received or property is received that differs "materially . . . in kind or extent"[30] from the partitioned property. The uncertainty lies largely with property that differs "materially…in kind or extent."

It is worth noting that the recent private letter rulings seem to emphasize a distinction between partitions that only involve one contiguous tract and partitions that involve more than one contiguous tract[31] although the older revenue rulings do not make that same distinction.[32] It is always hazardous to read too much into private letter rulings that is not expressed in the more persuasive authority.

So is a partition subject to the related party rules?[33] It would appear that partitions that are not "exchanges" are not subject to the related party provision.[34] Therefore, it would appear that transactions that are clearly not exchanges need not be reported to the Internal Revenue Service as is required for exchanges. Further clarification by the Service would be helpful.

FOOTNOTES

1 Harl, "Partition and the Related Party Rule," 13 *Agric. L. Dig*. 145 (2002).
2 I.R.C. § 1031(f).
3 I.R.C. § 1031. See generally 4 Harl, *Agricultural Law* § 27.03[8][a][ii] (2003); Harl, *Agricultural Law Manual* § 4.02[16] (2003).
4 I.R.C. § 1031(f).
5 S. Rep. No. 101-56, Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239. See Ltr. Rul. 9926045, April 2, 1999 (timber could be harvested within two year period).
6 Harl, "Income Tax Consequences on Partition and Sale of Land," 11 *Agric. L. Dig.* 113 (2000).
7 *Id*.
8 I.R.C. § 1001.
9 Treas. Reg. § 1.1001-1(a).
10 Rev. Rul. 56-437, 1956-2 C.B. 507.
11 E.g., Ltr. Rul. 200303023,Oct. 1, 2002.
12 *Id*.
13 Rev. Rul. 73-476, 1973-2 C.B. 301.
14 *Id*.
15 Ltr. Rul. 200303023, Oct. 1, 2002.
16 See *Id*.
17 Rev. Rul. 79-44, 1979-2 C.B. 265.
18 *Id*.
19 See I.R.C. § 1001(a).
20 See note 11 *supra*.
21 Rev. Rul. 79-44, 1979-2 C.B. 265.
22 Rev. Rul. 73-476, 1973-2 C.B. 301.
23 Ltr. Rul. 200303023, Oct. 1, 2002.
24 Rev. Rul. 56-437, 1956-2 C.B. 507.
25 Ltr. Rul. 200303023, Oct. 1, 2002.
26 Ltr. Rul. 9327069, Feb. 12, 1993.
27 *Id*.
28 Ltr. Rul. 9633028, May 20, 1996.
29 *Id*.
30 Treas. Reg. Sec. 1.1001-1(a).
31 E.g., Ltr. Rul. 9633028, May 20, 1996 (property was contiguous and properly treated as single parcel; not sale or exchange).
32 E.g., Rev. Rul. 73-476, 1973-2 C.B. 301 (three individuals had undivided interests in three separate parcels with land owned as tenants in common; gain or loss not recognized).
33 See I.R.C. Sec. 1031(f).
34 *Id*.