Partnership Issues

IRC §1031 specifically excludes exchanges of partnership interests from non-recognition treatment. Thus, §1031 does not apply to an exchange of interests in a partnership regardless of whether the interests exchanged are general or limited partnership interests; interests in the same partnership; or interests in different partnerships, even if both own the same kind of real property.

A partnership, however, may exchange real property under §1031, as long as the partnership meets the requirements that apply to all exchange transactions (i.e., same taxpayer starting and completing the exchange, both the Relinquished and Replacement Properties will be held for investment or business purposes, etc.).

An important issue when addressing exchanges involving partnerships is the individual investment objectives of the partners. When the entire partnership wants to structure a Tax Deferred Exchange, it is clear that the transaction can qualify under §1031. Problems arise, however, when one or more of the individual partners have different investment objectives.

A commonly asked question is "Can a valid exchange still be structured if one of the partners drops out of the partnership?" Often one or more of the partners desires to withdraw from the partnership and receive cash or other property in return for their partnership interest. Most partnership issues can be resolved with advanced planning. Partners that may want to separate in future investments or sell the existing asset for cash should consult with their tax advisors before structuring the transaction.

Distributing an undivided interest: Although there are many structures, many practitioners believe that there is less risk of an exchange being disallowed on audit if the partners desiring to receive cash on the sale of the Relinquished Property (cash-out partners) receive a distribution of their partnership interest in the form of an undivided interest in the Relinquished Property prior to the closing of the sale. Then, as long as there are at least two partners (one of which was a partner prior to the redemption), this leaves the partnership in existence to accomplish the 1031 Exchange. At the closing, the surviving partnership and each of the former partners convey their respective interests in the Relinquished Property, with the former partners receiving cash, and the Qualified Intermediary receiving the net proceeds due the partnership to enable the partnership to complete the exchange when it locates Replacement Property. Completing the redemption of the cash-out partners as far in advance of the sale, and if possible, prior to the execution of the contract of sale for the Relinquished Property, is generally recommended.

Liquidate partnership and distribute tenant-in-common interests: Liquidate partnership and distribute tenant-in-common interests: Another possible solution is to liquidate the partnership prior to the exchange and distribute to each partner a tenant-in-common interest in the Relinquished Property. It is advisable to transfer ownership to the individual Exchangers as far in advance of the exchange as possible. If a distribution or dissolution occurs shortly prior to the exchange, an issue can arise. That is, whether the Relinquished Property was sold by the tenants in common or by the entity (the partnership). To avoid this, a respected tenant in common ownership must be created through proper planning. In addition, this issue may be avoided through the strategy of distributing an undivided interest to the cash-out partners only (prior to sale), without liquidation, allowing the partnership to survive and complete the exchange.

"Drop and Swap" and "Swap and Drop": "Drop and Swap" transactions are when a Partnership distributes the Relinquished Property to the partners shortly before the exchange and "Swap and Drop" transactions are when the Partnership distributes the Replacement Property to the partners shortly after the exchange. These transactions are considered aggressive since under these structures, the partnership's prior holding period is not attributed to the individual Exchanger (the distributee of the property) that is completing the exchange. Hence, the Exchanger may be considered to be acting on behalf of the partnership, and the sale and gain recognition will be attributed to the partnership. Accordingly, "Drop and Swap" and "Swap and Drop" transactions should only be considered with the guidance of a tax advisor.

If distributing an undivided interest of the partnership property or dissolving the partnership well in advance of the exchange is not possible, the partners who want to exchange may consider one of the following: purchase of the interest of a retiring partner; sale by the partnership of the Relinquished Property for cash and an installment note; or a partnership division.

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Partnership Issues (CONT.)

Purchase of the interest of a retiring partner: This technique can be implemented before or after a §1031 Exchange. If done before the exchange, the partners who want to exchange contribute additional equity which is used to buy out the retiring partner(s). The partnership (with fewer partners) then enters into an exchange. The partnership must acquire Replacement Property which has the same or greater value compared to the Relinquished Property to fully defer taxes. If the partner buy out occurs after the exchange, the partnership typically refinances the Replacement Property received in the exchange to generate the cash necessary to buy out the retiring partner(s).

Sale of the Relinquished Property for cash and an installment note: This method involves having the buyer of the Relinquished Property pay with cash and an installment note; the cash is used by the partnership in the exchange and the retiring partner receives the installment note in redemption of his or her partnership interest. If at least one true payment is paid in the following tax year, it should be considered a valid installment note and receive installment sale treatment under I.R.C. §453. Many tax advisors suggest that at least 5% of the total payments of the note be made in the next tax year.

Partnership division: This technique can be done before, after and possibly during an exchange. Using the partnership division rules of I.R.C. §708(b)(2), a partnership can divide into two or more partnerships. If a new partnership contains partners, who together, owned more than 50% of the original partnership, it is deemed to be a continuation of the original partnership. Although there may be more than one "continuing partnership", only the continuing partnership which has the greatest fair market value (net of liabilities) will continue to use the Employer Identification Number (EIN) of the original partnership. All other partnerships resulting from the division will obtain a new EIN.

For example, let's assume that a partnership is comprised of John and Jeff (each owns a 50% interest) who no longer want to be partners; John wants to do a 1031 Exchange but Jeff wants to sell his interest and "cash out". John-Jeff Partnership would divide into two partnerships; John-Jeff Partnership I (John owns a 99% interest and Jeff owns a 1% interest) and John-Jeff Partnership II (John owns a 1% interest and Jeff owns a 99% interest). John-Jeff Partnership would transfer the partnership property 51% to John-Jeff Partnership I and 49% to John-Jeff Partnership II, as tenants in common. Upon sale of the Relinquished Property, 51% of the sale proceeds would go to a Qualified Intermediary for John-Jeff Partnership I's 1031 Exchange and 49% of the proceeds would be distributed to the John-Jeff Partnership II for further distribution to the individual partners. As a result, John has a 99% interest in the partnership which owns the Replacement Property (and which continues to use the original partnership's EIN) and Jeff has received 99% of the cash value of his interest in the original partnership. After one to two years, John could buy Jeff's interest in John-Jeff Partnership I and complete the separation, provided their tax advisor was comfortable with that timing. Although partnership division may not be suitable for partners who want to immediately completely separate their holdings, it provides a way to achieve this over a period of time and still comply with the "held for" requirement of §1031.

Purchase of multiple properties by partnership: Although some authority exists to apply partnership division to situations where both partners want to exchange (but into separate properties); some advisors are not comfortable having their clients do so because only one of the resulting partnerships is permitted to continue to use the original partnership's EIN. They prefer that the partnership purchase multiple Replacement Properties. Applying this to our example, John-Jeff Partnership would exchange into two Replacement Properties and amend the partnership agreement to disproportionately allocate the respective income and depreciation from the properties to John and Jeff. Most advisors believe that at least 10% should be allocated to the minority partner. Accordingly, the John-Jeff Partnership would buy Whiteacre and Blackacre. John would be allocated 90% of the income and depreciation of Whiteacre and Jeff would be allocated 10%. The reverse would be applied to the allocation of income and depreciation relating Blackacre. After a period of time, determined by their tax advisor (and with no prearranged plan), John and Jeff could dissolve the partnership distributing Whiteacre to John and Blackacre to Jeff.

NOTE: It is our understanding that the California Franchise Tax Board will challenge (in an audit) this type of disproportionate allocation between the partners. Accordingly, taxpayers should receive advice and assistance from tax professionals familiar with federal and state issues relating to all structures.

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