Partnerships and Section 1031 Exchanges

Available Options for Partners and Partnerships

1031 Knowledge

Like any other taxpaying entity, a partnership (and a limited liability company taxed as a partnership, generally referred to herein as a "partnership") can engage in a like-kind exchange under IRC Section 1031 to defer capital gain taxes. Difficulties can arise, however, when the individual partners desire different outcomes with regard to the sale of property by the partnership. Some partners may wish for the partnership to stay together and do an exchange; others may want to do their own exchange with their portion of the property; still others may wish to receive cash and simply pay the tax. What alternatives are available to the partners?

PARTNERS DOING SEPARATE EXCHANGES

An exchanger must own real property to do a 1031 exchange. The fact that a partnership owns real property does *not* mean that the individual partners have an ownership interest in that asset which is independently exchangeable. The partners merely own partnership interests, and partnership interests are not real property. Therefore, if an individual partner were to do a 1031 exchange, the partner would have to convert his or her partnership interest into an interest in real property owned by the partnership.

One method for accomplishing this, known as a "drop and swap," involves the liquidation of the partnership interest by distributing a different type of interest in the real property owned by the partnership. This process of liquidating the partnership is the "drop." After completion of the drop, the (former) partners will have converted their partnership interests into exchangeable interests in the underlying property itself, as a tenant-in-common with the partnership. The property can then be sold, with the former partners each entitled to do what they wish (sale or exchange) with their respective interests.

Related to the "drop and swap" is the "swap and drop." This involves the same two steps but in reverse order. The partnership completes the exchange (the "swap") and then distributes an interest in the replacement property to the departing partner or partners.

ISSUES

If the drop appears too close in time to the swap, the partner's exchange may be deemed an exchange by the partnership under the *Court Holding* case (See Commissioner v. Court Holding Co., 324 U.S. 331, 65 S.Ct. 707 (1954). This depends on whether the partnership has agreed to sell the property before the drop occurs. Also, if the drop and the swap occur too close in time, the question arises whether the taxpayer ever really owned qualifying interest in the

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ASSET PRESERVATION INCORPORATED

HQ 800.282.1031 | NY 866.394.1031
apiexchange.com | info@apiexchange.com

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Regarding the above issues, a line of federal cases (*Bolker*, *Mason*, *Maloney*, etc.) provides taxpayer-friendly authority against challenges by the IRS. However, some state taxing authorities (notably, the California Franchise Tax Board) aggressively challenge 1031 exchanges and sometimes narrowly interpret these federal cases. Also, changes made in 2008 to the federal partnership tax return (IRS Form 1065) make it easier to detect when drop and swap transactions have occurred, thus making such transactions more vulnerable to challenge by taxing authorities.

THE CASH OUT METHOD

In some instances, a majority of the partners may want the partnership to complete an exchange, but one or more of the other partners may want to be "cashed out" with the sale of the relinquished property. One way to accomplish this is for the partnership simply to receive cash from the sale in an amount sufficient to purchase the departing partners' partnership interests. This cash, however, would be "boot," and would require the partnership to allocate the resulting gain among all of the partners.

EXCHANGES FOLLOWED BY CONTRIBUTION

When an individual completes an exchange and then immediately contributes the replacement property to an entity, or when an entity exchanges property immediately after receiving it as a contribution, an issue of whether property or a partnership interest was received could arise. Such an issue was resolved in the taxpayer's favor in the *Magneson* case, which involved an exchange by an individual, followed immediately by a contribution of the replacement property to a general partnership. The same logic used in *Magneson* was applied at the state level in the *Rago* case in California.

ELECTION UNDER SECTION 761

As stated above, partnership interests do not qualify for application of §1031. A very narrow exception applies to a partnership that has elected, under Section 761(a), not to be subject to the partnership taxation provisions of Subchapter K. The election applies only to a partnership: (i) organized and operating for investment purposes only and not for the active conduct of business; (ii) where the partners each directly hold title to the property as co-owners; (iii) where each owner reserves the right to separately take or dispose of his or her share of the property; and (iv) which has no active trade or business. If a partnership owning real property makes such an election, a partnership interest will be treated as an interest in the underlying assets and can be exchanged under §1031.

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