



## PARTNERSHIP ISSUES WITH EXCHANGES

Section 1031 of the Internal Revenue Code specifically excludes the exchange of Partnership interests. Many commentators suggest that by so doing Congress intended to stop the exchanging of "burned out" tax-shelter limited-Partnership interests. Unfortunately, the over broad language of the amendments prevents the exchange of ANY Partnership interest (General, Limited, or Multi-Member LLC). It is important to understand that even membership interests in Limited Liability Companies (LLC's) are deemed to be Partnership interests for the IRS.

Since then, Regulations for Delayed Exchanges further underscore the fact that the exchange of Partnership interests is excluded under §1031.

### HOW TO KNOW WHEN A PARTNERSHIP PROBLEM MAY EXIST?

#### I. TITLE TO THE PROPERTY

Where title to the property is in the name of a Partnership, we obviously have to deal with Partnership-exchanging concerns. Where title is in co-owners' (people's) names, as Tenants In Common, we must check the next area of concern.

#### II. PARTNERSHIP AGREEMENT

If the title is in co-owners' names, but a Partnership Agreement exists which includes the property as Partnership property, the Partnership owns the property for tax purposes even though record title may not be in the Partnership's name.

If we determine that title to the property is in co-owners' names, and there is not a Partnership Agreement for that particular property, we still have to check one more area, by reviewing Section III below.

### III. PARTNERSHIP TAX RETURNS

If a Partnership tax return has been filed for a particular property, that property is Partnership property for tax purposes even though title may not be in the name of the Partnership and even though there is no formal, written Partnership Agreement.

If we find any one of the foregoing elements present, we know we are dealing with a potential Partnership issue as regards a tax deferred exchange.

If the Relinquished Property is going to be treated by the IRS as Partnership property, we have to next examine whether the goals of the joint owners or "partners" are going to be served by completion of a tax-deferred exchange.

If all of the partners want to acquire the same Replacement Property, there is no problem.

### **PARTNERSHIPS ARE DEEMED TO BE AN ENTITY FOR EXCHANGE PURPOSES**

The Partnership, as an entity, may dispose of the Relinquished Property and the Partnership, as an entity, may acquire the Replacement Property. Real estate may be exchanged for real estate by that same Partnership in a tax deferred exchange.

Often, however, not all of the partners want to be part of an exchange. This could prevent the Partnership, as an entity, from disposing of the Relinquished Property and acquiring the Replacement Property.

When a Partnership is in title and is going to act as the Seller of the Relinquished Property, it may be desirable to buy-out the non-exchanging partners' interests in the Partnership prior to the sale of the Relinquished Property. The Partnership could then complete the exchange as an entity. It is important that this methodology be planned and has an independent business purpose apart from just the completion of a tax deferred exchange.

It may also be possible to buy-out the non-exchanging partners' interests in the Partnership after acquisition of the Replacement Property if the non-exchanging partners are willing to wait for their share of the Relinquished Property disposition proceeds until after the Replacement Property is acquired in the partnership's tax deferred exchange.

If it is not possible to buy-out the non-exchanging partners prior to disposition of the Relinquished Property or after the acquisition of the Replacement Property, the Partnership may want to consider dissolving the Partnership and distributing interests in the Relinquished Property to the partners in proportion to their Partnership interest as Tenants-In-Common prior to even contemplating an exchange.

You will want to then create a Tenancy-In-Common Agreement to re-classify their previous Partnership interest into an ownership interest to fulfill the IRS guidelines given in a recently promulgated Revenue Procedure.

The individual partners (who now become "Tenants in Common") may then sell or relinquish their newly acquired undivided real property interests for individual exchange purposes or for outright sale depending on their individual wishes.

## **ALL PARTNERSHIP PROPERTY MUST BE CONVERTED UPON DISSOLUTION**

The IRS may characterize the acquisition of the property interest from the Partnership as ineligible for an exchange! The IRS may argue that the property was not held for investment purposes because it was immediately disposed of to acquire the Replacement Property. As that property was acquired only for the purpose of its relinquishment in a tax deferred exchange, it may not have been held for investment purposes.

Revisions to the Tax Code in 1989 (§704) may make the distribution of the property to the partners in the breakup of the Partnership a taxable event for one or more of the partners under certain circumstances particularly if the only reason for the dissolution is to allow one or all of the partners to complete a tax deferred exchange.

In the case where there are more properties than just the Relinquished Property being held by the Partnership, the exchanging partners might receive an undivided interest in the Relinquished Property in partial or complete dissolution of their Partnership interest. In this circumstance, the IRS might still argue that the recently received property interest was not held for investment purposes.

Another possible solution is to have the Partnership, as an entity, dispose of the Relinquished Property. The non-exchanging partners would receive cash or other non-qualified property from the Relinquished Property disposition. Because the Partnership, as an entity, disposed of the Relinquished Property, the cash or other non-qualified property which has been received by the non-exchanging partners would be normally taxable to the Partnership and be eligible for the exchange. However, the non-exchanging partners can make a special election which will result in the non-exchanging partners being taxed rather than the Partnership. The Partnership, as an entity, could then complete the tax deferred exchange.

## STEPS TO DISSOLVING A PARTNERSHIP

Where a Partnership holds title to the Relinquished Property; and that Relinquished Property to be sold is all of the Partnership's property; and Code §704 will not deem the breakup to be a taxable event; and it is determined that the best course to follow is to dissolve the Partnership and distribute the Relinquished Property to the individual partners; the following steps need to be taken:

**Step One:** Formally terminate any formal written Partnership Agreement.

**Step Two:** Have the Partnership's CPA file a final Partnership tax return and formally elect out of Partnership tax treatment.

**Step Three:** Have the Partnership convey out the property to the individual partners in undivided interests proportionate to their Partnership interest. This deed is exempt from excise tax if the property happens to be located in the State of Washington.

**Step Four:** Have the individuals dispose of the Relinquished Property, by sale or exchange, as the case may be.

Even where the title to the property is held by individual joint owners, the Partnership problem must be considered. Where the record owner(s) of the property are individuals, but there is a formal written Partnership Agreement or federal Partnership tax returns have been filed, steps one, two and four still need to be taken.

The more time that elapses between the steps taken to qualify the Partnership interest for an exchange and the disposition of the Relinquished Property, the less likely the IRS will challenge the tax deferred exchange. It is recommended that the termination of the Partnership occur before an offer for the Relinquished Property is accepted as the dissolution should have an independent business purpose.

It is critical that the taxpayer (former partner) retain an individual ownership of the Replacement Property for a period of time. The taxpayer should not form a Partnership to own the Replacement Property shortly after the exchange. The taxpayer should not contribute the Replacement Property to a Partnership or otherwise dispose of the property shortly after the exchange.

It is best, whenever possible, for each Exchangor (former partner) to acquire a 100% interest in a Replacement Property. This would deprive the IRS of the argument

that some of the joint owners of the Relinquished Property left one property as partners only to go into another property as partners.

If joint ownership is involved in the acquisition of the Replacement Property, care must be taken to avoid the appearance of Partnership ownership of that Replacement Property.

## SUMMARY

The disposition of Partnership property in a tax deferred exchange is many times a challenge. Joint owners or tenants in common may easily be thrown into Partnership tax treatment. Because Partnership interests cannot be exchanged for real estate and qualify for tax-deferral, there is always a problem if not all of the joint owners, tenants in common, or deemed partners want to do a tax deferred exchange.

If the Partnership entity (it is important that it be acting as an entity) is going to be disposing of the Relinquished Property, the following alternatives are possible:

1. Have the exchanging partners buy-out the non-exchanging partners at a time prior to the completion of a tax deferred exchange.
2. Distribute portions of the Relinquished Property to the exchanging partners in partial or complete dissolution of their Partnership interest. The exchanging partners would then dispose of the recently acquired property interests as individuals and enter into the exchange as individuals or as a tenant in common.

3. Distribute non-qualifying property to the non-exchanging partners and have them elect to be taxed on its receipt rather than having the Partnership recognize receipt of the non-qualifying property.
4. Have the Partnership complete the acquisition of the Replacement Property. The exchanging partners would then later buy the Partnership interest of the non-exchanging partners, after the completion of the tax deferred exchange.
5. If the Partnership entity is not going to be the Seller of the Relinquished Property, the steps suggested to dissolve the Partnership, distribute the property, and then sell the property must be completed. The former partners would then complete the exchange or sell as individuals depending on their individual objectives.
6. None of the alternatives suggested is risk free or will be likely to please all of the partners. The partners must work closely with their tax advisors, attorneys, and Qualified Intermediary well in advance of the Relinquished Property closing to increase the likelihood of success.

THIS LITERATURE IS PRODUCED TO PROVIDE A GENERAL OVERVIEW OF THE TAX-DEFERRED EXCHANGE PROCESS. YOU SHOULD NOT DEPEND UPON THIS LITERATURE WHEN DETERMINING WHETHER OR NOT YOU MAY WANT TO COMPLETE A TAX-DEFERRED EXCHANGE. YOUR DECISION TO DO SO RESTS ENTIRELY WITH YOU, WITH THE ADVISE OF YOUR OWN ACCOUNTING AND LEGAL PROFESSIONAL, WHETHER THAT BE YOUR ACCOUNTANT, C.P.A. OR ATTORNEY. WE ARE QUALIFIED INTERMEDIARY'S AND ARE BY I.R.S. REGULATION PRECLUDED FROM ACTING AS YOUR QUALIFIED INTERMEDIARY IF WE HAVE BEEN YOUR ATTORNEY OR ACCOUNTANT DURING THE TWO(2) YEAR PERIOD BEFORE YOUR EXCHANGE. AS YOU CAN SEE, OUR SERVICES AS FACILITATOR DO NOT REPLACE THE TRULY PROFESSIONAL SERVICES OF YOUR ATTORNEY OR ACCOUNTANT!