# Structuring Partnership Exchanges

Many real estate partnerships are formed for the purpose of owning a specific parcel of real estate. When the partners decide it's time to sell, some or all may want to go their separate ways. If the partners want to defer the gain from the sale, however, proper structuring is required.

If all the partners of the partnership want to exchange and keep the partnership together, then the partnership itself can do the 1031 exchange. Difficulties occur when one or more of the partners want to withdraw from the partnership either by cashing out or exchanging into a separate piece of property. This article explores the various techniques that can be used to effectuate a 1031 exchange if one or more of the partners do not desire to continue the partnership. The techniques discussed below are equally applicable to members of a limited liability company and beneficiaries of a Massachusetts nominee trust if the beneficiaries treat their relationship, for tax purposes, as a partnership.

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***1. DROP AND SWAP TECHNIQUE***

The most common technique, a "drop and swap" exchange involves the partnership making tax free liquidating distributions of undivided fractional interests in the property to each of the partners as tenants in common. Each former partner would then own a percentage interest in the real estate outright, as a tenant in common, and would be free to sell or exchange his or her interest. Although implementation of the drop and swap is relatively simple, timing and attention to form are vital components of this technique.

For a multitude of reasons, the liquidation should occur as far in advance of the sale as practical. The IRS has argued that former partners exchanging fractional interests in real estate were not holding the same for investment purposes (as required under Section 1031), but rather they were holding the interests solely to exchange the same. Placing time between the liquidation date and the sale date reduces the effectiveness of this "qualified use" argument. The liquidation should also occur prior to the execution of the purchase and sale agreement by the partnership, otherwise the IRS could argue, relying on Court Holding Company, 33 AFTR 593, 324 US 331, 89 L Ed 981 (1945), that the transaction must be viewed as a sale of the property by the partnership, the intervening distribution notwithstanding. Human nature being what it is, however, most drop and swap planning occurs shortly before the sale, namely because the partners weren't aware of the complexities involved.

Once the partnership is liquidated, the co-owners must respect the form of their new relationship. The entity that owns the real estate will file a final partnership tax return reflecting the liquidating distributions. The entity's bank account will be closed. Income and expenses will be received and paid proportionately by the co-owners. The co-owners should enter into a tenants in common agreement, to avoid the argument that they remain a partnership for tax purposes. A property manager should be appointed to manage the property. The former owners should also consult the provisions of Rev. Proc. 2002-22 which sets forth the documents which must be supplied and the tests that must be met in order to obtain a ruling from the IRS as to an exchange of an undivided interest in real estate.

Sometimes the partnership finds it preferable to redeem the non-exchanging partner's interest prior to the sale by distributing an undivided interest in the real estate to the partner. When the real estate is sold, there will be two owners, the redeemed partner and the re-configured partnership. The partnership would do its exchange, and the former partner would recognize gain on its sale, or enter into its own 1031 exchange. Another variation is to redeem the non-exchanging partner's interest with a promissory note (and not a fractional interest in the real estate) secured by a mortgage on the property. The mortgage would be satisfied from the sales proceeds, leaving less equity for the partnership to reinvest. This structure eliminates the possibility of a 1031 exchange for the redeemed partner.

Other factors to consider, in no particular order, are (i) asset protection (the tenant in common owners may want to take title through single member LLCs); (ii) triggering due on sale clauses if the partnership real estate is encumbered by a mortgage; and proceeds from the sale should be distributed to each owner according to their ownership percentages (despite any prior arrangements in the partnership agreement).

***2. ALLOCATION TECHNIQUES***

Some partnerships have attempted to use a special allocation of a portion of the cash and the associated gain to the departing partners. This gain would increase the departing partner's basis in their partnership interests, and the partners would also have offsetting capital losses on the receipt of their share of the sales proceeds in redemption of their interests (i.e. they would not be double taxed). If any of the gain reflects depreciation recapture, however, the departing partners would have ordinary income and capital losses, which would not offset, resulting in adverse tax consequences. The biggest issue with this technique is whether the special allocation of cash/gain has substantial economic effect under the tax rules for partnerships.

***3. INSTALLMENT SALE***

Another alternative is to have the partnership sell the property in return for cash and a promissory note equal to the amount due to the departing partners. The note would then be distributed to the departing partners in liquidation of their interests. In order to satisfy the departing partner's desire to receive his cash, the note typically would provide for 98% or 99% of the payments thereon to be made a short time after closing, with the remaining payments to be made after the beginning of the next tax year, thus qualifying for installment reporting under Section 453(b)(1). If there are questions concerning the buyer's financial ability to satisfy the note, a standby letter of credit might be obtained by the parties.

This method works because no gain or loss is recognized by the partnership on receipt of the installment note (although there are certain exceptions to nonrecognition under Section 453, such as sales of inventory and depreciation recapture). Furthermore, the distribution of the installment note to the departing partners in redemption of their interests in the partnership also should not result in recognition of gain under Sections 453 and 731.

Instead, the departing partners would recognize gain only as payments are received on the note. The reconstituted partnership would purchase replacement property, which would qualify for tax deferral under Section 1031 because the partnership had held the relinquished property and acquired the replacement property.

***4. SWAP AND DROP***

A swap and drop involves the post exchange redemption of a partner. The partnership itself would do the exchange and acquire the replacement property. Shortly thereafter, the partnership would refinance or obtain an equity line on the replacement property using the cash to redeem the departing partner's interest. Alternatively, if the property cannot be further encumbered, the remaining partners could make a cash contribution to the partnership, using the cash to redeem the departing partner's interest. The advantage to this technique is that the 1031 issues are all but eliminated. The disadvantage is that the partnership now has to come up with the cash to redeem the departing partner.

Structuring 1031 exchanges for partnerships can be intricate, and partnerships considering an exchange should consult their tax advisors as far in advance as possible to evaluate and ultimately implement the appropriate technique.

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