# PARTNERSHIP ISSUES IN A 1031 EXCHANGE

An important issue when addressing partnership exchanges is the investment objective of the various partners. When all of the partners want to exchange, it's easy to structure an exchange under Section 1031. It is, however, more difficult when partners have different investment objectives. Under IRC §1031(a)(2)(D), the IRS expressly prohibits the exchange of partnership interests in a 1031 exchange transaction.

A commonly asked question we receive is "how can individuals that hold title in a partnership go their separate ways?" Some may want to cash out; others may want to continue down the 1031 exchange path. Most partnership issues can be resolved with advanced planning and communication. Here are three options available in such a scenario:

**Distributing an undivided interest:** Many practitioners believe that there is minimal risk of an exchange being disallowed on audit if the "cash out partners" receive a distribution of their partnership interest as an undivided interest prior to the closing of the sale. As long as there are at least two remaining partners who owned more than 50% of the partnership before the redemption, the remaining partnership can complete the §1031 exchange. At closing, the surviving partnership and each of the former partners convey their interests in the Relinquished Property, with the former partners receiving cash. The Qualified Intermediary receives the net proceeds due the partnership, which enables 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, is highly desirable.

**Liquidate partnership and distribute tenancy-in-common interests:** Liquidate the partnership prior to the exchange, and distribute a tenancy-in-common interest to each partner. 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 (or shortly after the exchange), the key issue is whether the Relinquished Property (or Replacement Property) was "held for productive use in a trade or business or for investment purposes." This qualified use requirement must be met by the individual Exchanger for the exchange to be valid, and is problematic when the distribution occurs within close proximity to the sale or purchase transaction. Conversely, the qualified use issue may be avoided by distributing an undivided interest to the cash-out partners prior to sale, thereby allowing the partnership to survive and complete the exchange.

**"Drop and Swap" and "Swap and Drop":** "Drop and Swap" transactions occur when a Partnership distributes the Relinquished Property to the partners shortly before the exchange. Conversely, "Swap and Drop" transactions occur when the Partnership distributes the Replacement Property to the partners shortly after the exchange. These transactions are considered aggressive since the partnership's prior holding period is not attributed to the individual Exchanger. Hence, the Exchanger may not be able to satisfy the §1031 qualified use ("held for") requirement.

Timing, again, is crucial with all of these options. Consult with your tax adviser.


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***Options When Advanced Planning is not Possible***

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 have the following options at their disposal as well:

**Purchase 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 smaller partnership 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).

**Sell the Relinquished Property for cash and an installment note:** Under this method, the buyer of the Relinquished Property purchases the property with both 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 their partnership interest. If at least one payment is made in the following tax year, it should be considered a valid installment note and receive installment sale treatment under I.R.C. §453. Most tax advisors suggest that at least 5% of the total payments of the note be made in the next tax year.

Both of the above options (as well as distributing an undivided interest to a retiring partner) require that after the buy-out or redemption, there must be at least two remaining partners who owned more than 50% of the partnership to avoid a technical termination of the partnership and ensure that the partnership continues to exist to satisfy the “held for” requirement.

Here are two additional options where partners are willing to cooperate:

**Divide the partnership**: This option can be utilized 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 want to dissolve the partnership. John wants to do a §1031 exchange but Jeff wants to sell his interest and “cash out ”. The 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). The partnership would then 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.

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As a result, John has a 99% interest in the partnership which owns the Replacement Property (which continues to use the original partnership's EIN) while Jeff receives 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, based on a consultation with his tax advisor. Although partnership division may not be suitable for all partnership scenarios, it provides a way to achieve separation over a period of time and still comply with the "held for" requirement of §1031.

**Purchase 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 with this because only one of the resulting partnerships is permitted to continue using 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% must be allocated to the minority partner. Accordingly, the John-Jeff Partnership would buy Property 1 and Property 2. John would be allocated 90% of the income and depreciation of Property 1 and Jeff would be allocated 10%. The reverse would be applied to the allocation of income and depreciation relating to Property 2. After a period of time determined by their tax advisor (and with no prearranged plan) John and Jeff could dissolve the partnership distributing Property 1 to John and Property 2 to Jeff.

Based upon the complexity of these scenarios, it's imperative that you consult with your tax adviser before considering any of these options.*

**Peak 1031 Exchange, Inc. does not provide legal or tax advice.  Always consult with your attorney or tax adviser.*


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