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Partnerships and §1031 exchanges: Available options - by Pamela Michaels

December 04, 2018 - Front Section

Partnerships hold significant assets in multi member LLC ownership structures. Like any taxpayer, a partnership (and a limited liability company taxed as a partnership) can engage in a like-kind exchange under IRC Section 1031 to defer paying tax on capital gains. Difficulties can arise, however, when individual investors desire different outcomes with regard to the sale of property by the partnership. Some investors 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 partnerships?

Members doing separate exchanges

A taxpayer must own a capital asset to do a 1031 exchange. The fact that a partnership owns a capital asset does not mean that individual investors in the entity owning the asset have an ownership interest in that asset. The individual investors merely own partnership or membership interests if the entity filing tax returns for the asset is a partnership or multi member LLC. Such interests are specifically excluded from Section 1031 under IRC Section 1031(a)(2)(D). Therefore, if an individual investor is interested in performing a Section 1031 exchange, the partner must convert his or her partnership interest into an interest in the capital asset owned by the partnership.

One method for accomplishing this, known as a "drop and swap," involves the liquidation of a partnership interest by distributing an interest in the property owned by the partnership. After completion of the "drop," the former partner will have converted his or her partnership interest into an interest in the actual property itself, as a tenant-in-common with the partnership. The property can then be sold, with the former partner and the partnership 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.

Holding period issues

Both the "drop and swap" and the "swap and drop" alternatives raise potential holding period issues. If the "drop" occurs close in time to the "swap" (or vice versa), there may be some question as to whether the relinquished property (or replacement property) was "held for investment." Also, 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)]. Clearly, the more time that passes between the "drop" and the "swap" (or vice versa), the better.

Regarding the above issues, a line of federal cases (Bolker v. Commissioner, 760 F.2d 1039 (9th Cir. 1985); Miles H. Mason, 55 T.C.M. (CCH) 1134 (1988); Maloney v. Commissioner, 93 T.C. 89 (1989) etc.) provides taxpayer-friendly authority against challenges by the IRS. However, some state taxing authorities (notably, the California Franchise Tax Board) aggressively challenge exchanges, and argue that they are not bound by 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.

Needless to say, this is an area that it is critical for partnerships to obtain clear guidance from tax counsel. A "drop down" modifies the owner of record and could violate the terms of any mortgage encumbering the property causing a due on sale provision to be triggered. In addition depending on the type of property at issue, a drop down could expose individual high net worth investors to liability for acts/omissions on the property if not properly structured.

Partners getting cashed out

In some instances, a majority of the investors may want the partnership to complete an exchange, but one or more of the other investors 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.

A better alternative, known as a partnership installment note (PIN) transaction, results in the gain associated with the "boot" being recognized only by the departing investors. In a PIN transaction, instead of receiving cash, the partnership receives an installment note in the amount necessary to cash out the departing investor(s). The note is transferred to the departing investor(s) as consideration for their partnership interests. If at least one payment under the note is to be received in the year following the exchange, then the gain associated with the note will be taxed under the IRC Section 453 installment method, and recognized only when the actual payments are received by the departed investor(s).

Election under IRC Section 761

As stated above, partnership interests are specifically excluded from the application of Section 1031. A very narrow exception applies to a partnership that has elected, under IRC Section 761(a), not to be subject to the partnership taxation provisions of Subchapter K. The election applies only to a partnership:

For investment purposes only and not for the active conduct of business;
Where the partners hold title to the property as co-owners;
Where each owner reserves the right to separately take or dispose of his or her share of the property; and
Which has no active trade or business.

If a partnership makes such an election, a partnership interest will be treated as an interest in the underlying assets, and can be exchanged under Section 1031.

As a “Qualified Intermediary” as defined in the Section 1031 regulations, Asset Preservation, Inc. is not able to provide legal or tax advice. Accordingly, you should review the details of your specific transaction with your own legal or tax advisor.

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