Exchanges Involving Partners and Partnerships – Reading the Tea Leaves

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Few types of tax-deferred exchanges tend to raise the amount of questions as those involving partners and/or partnerships. Since a 1994 article, several developments have come about that clarify this subject further, including an ABA Report issued by the members of the American Bar Association Tax Section. Attempting to predict how this subject will finally be settled is comparable to reading tea leaves, but let's put on the glasses and try to classify what we see.

There is no question of the permissibility of partnerships effectuating exchanges of real property that they own ("Relinquished Property") for property they wish to acquire ("Replacement Property"). However, it is also clear that a partner cannot exchange their interest in a partnership for an interest in another partnership, as only real or personal property fall under IRC § 1031. Since people frequently desire to trade into or out of a partnership, the base issue, then, is whether the restrictions on exchange of interests can be circumvented. This article will discuss the various structuring possibilities that have been utilized. For the purposes of this information, all of these structuring possibilities will be referred to as "Partner Exchanges".

Distribution Followed by Exchange

A common addition to dissolving a partnership is the sale of property owned by the entity. When such a dissolution and sale are contemplated, often one partner wishes to exchange, while the other seeks to "cash out" – take their portion and walk away. Therefore, in order to satisfy both partners, there is frequently a distribution of undivided interests in the Relinquished Property to each partner prior to the close of escrow. Then, the partner cashing out can sell his undivided interest to the buyer while the partner who is exchanging may swap his undivided interest for a Replacement Property.

Theoretically, there should be no problem with an exchange following a distribution. After all, distributions of property from a partnership generally do not constitute taxable events, and there is no prohibition against exchanging an undivided interest in one property for total ownership of another. Nevertheless, the IRS disallowed one exchange in a published ruling which followed a distribution from a wholly owned corporation.

this type (“Bolker”) was allowed by both the Tax Court and the Ninth Circuit Court of Appeals. In Bolker, a corporation distributed the Relinquished Property to the sole shareholder, who then effectuated a tax-deferred exchange for a Replacement Property. The IRS argued that the shareholder never held the Relinquished Property for a “qualified use”, i.e., investment or productive use in trade or business. However, the court ruled that since the shareholder’s intention was never to “liquidate the investment or use it for personal pursuits”, the property was held for a qualified use.

On the other hand, the IRS successfully attacked an exchange following a distribution of property from a partnership (“Chase”). In this scenario, a limited partnership executed a contract to sell an apartment complex which it owned. However, prior to the close of escrow on the sale of that property, the partnership distributed an undivided common interest in the Relinquished Property to one of its general partners. The general partner then tried to exchange the undivided interest for a Replacement Property of his choosing. The Service disallowed the transaction and this decision was upheld by the Tax Court; the reason being that the purported exchange was treated and accounted for by all parties involved as a sale, including the escrow agent. Of particular notice was that the general partner had held the deed from the partnership to him unrecorded for six months, until shortly before the close of escrow. In addition, the general partner evidently did not notify anyone of his interest in the Relinqushed Property, nor did he negotiate with the buyer on his own behalf. Furthermore, he was not credited with any income or charged with any expenses for the Relinquished Property for his supposed ownership period. Finally, the amount distributed to the general partner from the sale of the Relinquished Property was in fact the amount due him under the original partnership agreement, rather than the corresponding value of his supposed interest in the Relinquished Property.

The ABA Report acknowledges this issue and recommends incorporation of a rule that the qualified use of property by a partnership should be attributed to the partner to whom it is distributed. It reasons that “transferring…Relinquished Property to a partner who does not sell the property…should not bar the satisfaction of the qualified use by the…distributee/partner…The absence of taxpayer intent to liquidate an investment in the subject property…should be recognized as the appropriate standard for satisfying the ‘qualified use’ test of Section 1031.”

Exchange Followed by Distribution

There is an alternative way to structure such exchanges which will accommodate both an exchanging partner and a cashing-out partner in a partnership dissolution: the partnership exchanges the Relinquished Property for the Replacement Property, and then dissolves, allocating the Replacement Property to the exchanging partner and funds to the cashing-out partner.

The Tax Court has actually approved an exchange structured in this manner (“Maloney”). In this situation, a corporation effectuated an exchange, and subsequently distributed the Replacement Property to its shareholders. The Service argued that the exchange should be disallowed because the corporation’s qualified use was not within the scope of the regulations; the property was merely bought for distribution. However, the Tax Court upheld the exchange, citing that

later transfer.

The ABA Report addresses this type of exchange as well. It promotes allowing attribution of the partnership's qualified use of the Relinquished Property to the holding of the Replacement Property, notwithstanding the distribution of the Replacement Property to a partner at a later date.

Exchange Followed by Contribution

Often, an individual desires to effectuate an exchange and then contribute the Replacement Property to a partnership. The IRS has shown in the past they will challenge such transactions; as in one ruling where an exchange was disallowed on the grounds that the exchanger did not hold the Relinquished Property for a "qualified use". However, there is an example where the Tax Court and Ninth Circuit Court of Appeals upheld a case with the same attributes ("Magneson"). The Service contested the exchange, saying that the Replacement Property was not held for investment or use in trade or business. Nevertheless, both courts gave their approval by reason that the "new property is substantially a continuation of the old investment still unliquidated."

The ABA Report deals with this situation by urging the IRS to allow both scenarios to pass through with regard to partnership exchanges.

Partnership Taxation Issues

The Report also proposes several possibilities with regard to IRC § 1031 and partnership taxation rules that, just by themselves, are extremely complicated. Even though delving into these possibilities is beyond the focus of this article, anyone involved in an exchange should be aware that these rules raise questions that may affect them, depending on their situation.

First is the issue of whether or not the transfer of an interest in a partnership that has already sold its Relinquished Property, but has yet to acquire its Replacement Property, should prevent completion of the exchange. This comes into play because a "technical termination" of a partnership occurs when no less than 50% of the interests in its capital or profits are sold. A technical termination of a partnership causes its assets to be deemed contributed to a new partnership, the interests in which are automatically distributed to the partners left over. Therefore, the question is whether the procurement of Replacement Property by the so-called "new" partnership should be considered to have completed the exchange begun by the "old" partnership. The ABA Report contends that the answer is 'yes', due to the fact that the applicable Treasury regulation has been applied in the past to similar circumstances to prevent technical terminations from causing problematic effects.

The next situation deals with the "special allocation" rules. An allocation of taxable income or loss agreed upon by the partners is allowable only if said allocation has a "substantial economic effect." The ABA Report questions whether it is allowable for partners to specially allocate the gain recognized in an exchange to a partner who is not participating in the exchange, and whose interest in the partnership is about to be dissolved. After examining this situation a couple different ways, the ABA Report expresses that this type of allocation is suitable. Along the same lines,

exchange should be allotted among the partners when the Relinquished Property was originally contributed by only one of the partners, and therefore has "pre-contribution" gain.

Finally, the last matter dealt with by the ABA Report involves the reduction of liabilities, which results from the partnership's sale of the Relinquished Property. When a partnership transfers encumbered property, the ensuing relief of debt usually results in a constructive distribution of cash to the partners. The question posed here is, when an exchange straddles two tax years, whether the constructive distribution should be considered to have occurred at the end of the first tax year, or only after the receipt by the partnership of the Replacement Property and the associated increase in the partnership's debt in the second tax year. Expectedly, the Report concludes that an exchange should be treated as a single transaction, and that the reduction in debt should not result in an allocation of cash.

Analysis

It seems that favor is beginning to turn toward Partner Exchanges for several reasons. First, though the court in Chase did not uphold a Partner Exchange, the cases of Bolker, Magneson and Maloney were approved by the Tax Court and the Ninth Circuit Court of Appeals.

Secondly, it looks as though the Service itself is changing. Not only has its stance changed regarding reverse exchanges, but also, recently, any adverse rulings regarding Partner Exchanges have been few and far between. And third, there could be substantial reason to believe the IRS will consider the ABA Report favorably, since they have taken recommendations from the ABA Section of Taxation to heart in the past.

However, Partner Exchanges are still not guaranteed favorable tax treatment. For example, the IRS did not back down on Bolker, Magneson or Maloney; nor did they challenge the cases as "step transactions", which met with raised eyebrows. There is a possibility that a future court could prevaricate that the steps involved in Partner Exchanges, such as the distribution from or contribution to a partnership or the exchange, could actually be construed as an exchange of partnership interest for real property.

In addition, there are other risks associated with Partner Exchanges. For instance, both Magneson and Bolker arose prior to the IRC § 1031 1984 amendment prohibiting exchanges of partnership interests. On top of that, the "related party" rules could be applicable, causing the taxpayer's gain to be recognized. Under these guidelines, an exchange folds and becomes taxable if the related party property in question is disposed of prior to two years after the transaction. Although it is fairly certain that Congress did not anticipate these rules applying to Partner Exchanges, it is not out of the realm of possibility that the IRS could argue the true substance of any exchange structure discussed herein comprises an exchange between the partner and the partnership.

While it is obvious that risk cannot be removed from Partner Exchanges for now, the chances of success for the transaction will be greatly increased if it has true

distribution followed by an exchange:

1. The deed from the partnership to the exchanger should be executed as early as possible, preferably prior to any negotiations with the buyer of the property by the partnership, and it should not be held unrecorded.

2. The exchanger should be treated as a true owner of the property distributed for tax and economic purposes, and be credited and charged with any pro rata portion of income or expenses for the property.

3. The purchase agreement should be executed by the exchanger on his own behalf, and all documents relating to the transaction should clearly state that he is the owner of the portion of the property and is negotiating on his own.

4. The sales proceeds due the exchanger for his portion of the property should be consistent with the property's value, and not the partnership distribution percentage.

Conclusion

Although it is impossible to predict how Congress, the courts, and the IRS will resolve the outstanding issues regarding Partner Exchanges in the end, the tea leaves can be read to say: "Proceed, but use caution and good common sense."

*The article paraphrased above, "Exchanges Involving Partners and Partnerships – Reading the Tea Leaves" by Richard A. Goodman, Esq. – Goodman & Levine, can be read in its entirety by clicking on our Email Archives selection below.

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