COMMERCIAL INVESTMENT
Real Estate
The Magazine of the CCIM Institute

July.Aug.03

Tax Watch

Partnerships Can Use These Methods to Protect 1031 Gains

by John Mangham, CPA

John Mangham, CPA, is tl
regional vice president of :
Services in Atlanta. Conta
404.352.1031 or
jmangham@starker.com.

Property owners wishing to dispose of appreciated assets often use Internal Revenue Code Section 1031 exchanges to defer capital gains taxes. However, partnerships wishing to execute exchanges face unique challenges, particularly when individuals in the partnership have diverging investment goals or want to cash out. Partners who want to separate their interests in real property must proceed with caution as the partnership's dissolution very well may trigger the taxable gain they're trying to avoid.

Dissolution Strategies

In such cases, partnerships should investigate different strategies to complete a successful exchange. The following six options provide viable alternatives to taxable gain.

IRC Section 761(a) Election. While difficult to achieve, this is the first step a partnership should try when structuring an exchange of this nature. Section 761(a) allows a group to avoid being categorized as a partnership for tax purposes. To qualify, the partnership should meet the following conditions:

• The group has chosen to be treated as a partnership pursuant to its state's partnership laws and has filed partnership returns in prior years.
• The group has limited involvement in the property's operation. For example, raw land, with its minimal management requirements, is an optimal asset in this respect.
• Few, if any, restrictions exist on the co-owners' rights to sell their interests individually.
• No provisions of the partnership agreement require a majority vote to transfer the asset.
• Each owner has been allocated a constant pro rata share of income and loss based on its share.

A partnership usually can amend an existing agreement to fulfill the above criteria, assuming it can do so without affecting its operation. If it meets these criteria, a partnership can make an affirmative election by filing with the Internal Revenue Service no later than the tax deadline in the year it wishes to obtain the election benefits.

Termination Through Distribution. This procedure requires the partnership to terminate under IRC Section 708(b)(l)(A) — which states that no partners can continue to carry on any of the partnership's business ventures — and distribute its assets. The exchange property then is transferred to the partners to be held as tenant-in-common interests. This method works well when the partnership owns a single property asset; otherwise, care should be taken to avoid the gain recognition on other low-basis assets.

To accomplish termination through distribution, partners should cease all partnership activity in the tax year prior to the one in which the exchange occurs, and each former partner should file taxes separately and take a prorated share of income and depreciation.

Since the tax code does not specify how long the property should be held individually, a one-year minimum is suggested. Once the now tenant-in-common owners have held the property for an extended period, they each can exchange their undivided interests into separate replacement properties.

Although the IRS could argue that the partnership distributed the property primarily for the purpose of facilitating the exchange, the risk should be minimal, provided the tenant-in-common owners hold the property for a sufficient time period.

Redemption and Allocation. This technique involves amending the partnership agreement to allocate gain to the partners who are cashing out. When the property sells, the partnership uses a portion of the proceeds to acquire the replacement property and distributes the remaining proceeds to the withdrawing partners in complete liquidation of their interests. This complex technique should be considered only if each partner has been advised of his individual tax ramifications on the transaction.

Partial Distribution. A variation of the allocation technique is when the partnership distributes an undivided interest in the property to those partners who wish to withdraw and liquidate or exchange their interests separately. After the partnership and the withdrawing individuals own and operate the property for a period of time as tenants in common, they sell the property; the partnership then exchanges its interest for a replacement property and the withdrawing individuals exchange or receive cash.

In this scenario, the partnership and its new co-owners must avoid appearing as if they are still operating a partnership. Thus, a period of separate ownership operation is recommended.

With this technique, the IRS might argue the retiring partners' allocation of gain lacks substantial economic substance — a violation of IRC Section 704(b)(2) — because the partners receive the same cash value for their shares regardless of the modified allocation at the partnership level. To counter the IRS' argument, the individuals might agree to sell for a lower price to indicate a relative valuation discount arising from a non-controlling interest. The partnership also must be careful not to unintentionally terminate by selling 50 percent or more of its total interest in capital or profits pursuant to IRC Section 708(b)(1)(B).

Third-Party Sale. In this approach the partners who wish to withdraw sell their partnership interests to third parties who want to become partners, and the partnership can increase its basis in the property by making an IRC Section 754 election. Again, the partnership must be careful not to sell 50 percent or more of the total interest in its capital or profits to avoid termination.

Purchase of Multiple Properties. Sometimes none of the partners want to retire from the partnership but simply prefer to own different assets due to different investment goals. The partnership would exchange its existing property for multiple replacement properties, each meeting the requirements of the individual partners. In such cases, the partnership agreement is amended to provide for income allocation and deductions to the specific partner or partners interested in the benefits of the particular property within the portfolio. Over time, the partnership can then distribute the specific properties to each designated partner. Each partner is then free to operate, dispose of, or exchange his individual asset as he chooses.

Dissolving a partnership after an exchange without triggering gain is challenging. Commercial real estate professionals should consult with a tax professional about the best method for managing such transactions.