Partnership Issues

Partnerships, like individuals and corporations, can take advantage of a like-kind exchange under IRC Section 1031. If ABC Partnership owns an office building, the ABC Partnership can defer the recognition of capital gains on the sale of that office building by replacing it with like-kind property in an exchange that meets the requirements of IRC Section 1031.

Frequently, however, one or more of the partners want to go in a different direction. Sometimes one partner wants to cash out or the partners have conflicting investment objectives. When this is the case, advanced planning is necessary to allow the partners and/or the partnership to take advantage of an exchange.

Advanced planning is needed because IRC Section 1031(a)(2)(D) specifically excludes the exchange of partnership interests in a tax-deferred exchange. So while a partnership can do an exchange, the individual partners cannot use an exchange to dispose of or acquire their partnership interest.

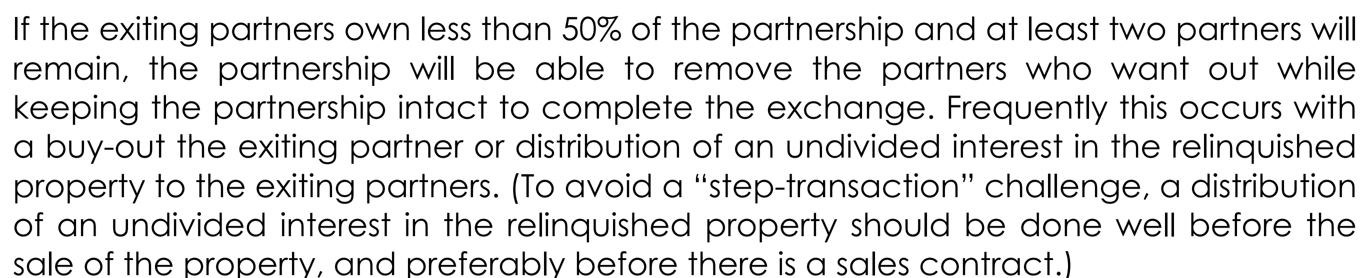
This article will discuss a several of options used to complete like-kind exchanges when one or more members of a partnership want to go their separate ways, but it is extremely important to seek tax advice from an attorney or CPA. There is not a "one size fits all" work around, and without proper planning the consequences can be devastating.

When a partnership has considered its exit strategy well in advance of the disposition of the relinquished property, one option is to dissolve the partnership and distribute the property to the partners as tenants in common. This option is attractive because it allows all partners the freedom to pursue their own objectives based on their individual investment values and basis outside the confines of the partnership.

It is important to understand this option is considered aggressive when done in conjunction with the sale of the relinquished property. Commonly referred to as a "drop and swap", the risk is the individual partners, who only acquired the property immediately prior to the sale, do not have a history of owning the property for business or investment purposes. This lack of a "qualified use" would be problematic in an audit.

When timing concerns prevent liquidating the partnership there may be other options. Available alternatives will depend on (1) if the partnership can be preserved despite the exiting partners, and (2) if the exiting partners want to preserve their ability to complete an exchange of their own.

National Exchange Titleholder 1031 Co. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice.



If the exiting partners own less than 50% of the partnership and at least two partners will remain, the partnership will be able to remove the partners who want out while keeping the partnership intact to complete the exchange. Frequently this occurs with a buy-out the exiting partner or distribution of an undivided interest in the relinquished property to the exiting partners. (To avoid a "step-transaction" challenge, a distribution of an undivided interest in the relinquished property should be done well before the sale of the property, and preferably before there is a sales contract.)

In addition to the partner removal options above, a taxpayer (working with their CPA or tax attorney) may also consider the following advanced structuring options:

- Sell relinquished property for cash and an installment note: Under this structure the buyer purchases the relinquished property with cash and an installment note. The cash goes into the exchange for the partnership and the retiring partner receives the installment note in redemption of his or her partnership interest. If at least one true payment is paid 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.

- Partnership division: Under 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, which avoids the "qualified use" problem of the "drop and swap". A partnership division provides a way to achieve this over a period of time, but it may not be suitable for partners who want to immediately completely separate their holdings.

If the exiting partners are looking to defer their portion of the gain associated with the sale of the relinquished property, the structuring options are limited. If the partners have not planned far enough in advance to take advantage of a liquidation, they may need to stay together through the exchange. In a partnership diversification exchange, each partner (or group of partners) identifies replacement property for the partnership to acquire in the exchange. The partnership agreement would then be modified to disproportionately allocate the respective income and depreciation from the properties. At some point in the future the partnership would be dissolved and each partner (or group of partners) would take their respective property. It is important the ultimate dissolution of the partnership is not part of a prearranged plan. There is also some authority that would support the use of a partnership division in this scenario, but there is no final decision on the issue, so many advisors prefer to take the diversification approach.

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