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Exchanges Involving Partners and Partnerships

"Reading the Tea Leaves"

By Richard A. Goodman

Introduction

Few types of tax-deferred exchanges raise as many questions as those involving partners and partnerships. Since my 1994 article, there have been several developments which have shed further light on this subject, including the issuance of an ABA Report made by members of the American Bar Association Tax Section. Predicting how this issue ultimately will be settled is a bit like reading tea leaves, but let's put on reading glasses and divine what we see.

There is no dispute as to the permissibility of an exchange by a partnership of real property which it owns (the "Relinquished Property") for real property which it wishes to acquire (the "Replacement Property"). It is equally clear, however, that a partner is not permitted to exchange his interest in one partnership for an interest in another partnership. Since individuals frequently wish to trade into or out of a partnership, the real issue is whether the prohibition on exchanges of partnership interests can be circumvented. In this article, I will discuss the status of the various structuring alternatives which have been used. I will refer to all of these structuring as, "Partner Exchanges."

Distribution Followed by Exchange

A common adjunct to a partnership dissolution is the sale of property owned by the partnership. When such a dissolution and sale is contemplated, frequently one partner (the "Exchanging Partner") wishes to exchange while the other partner (the "Selling Partner") seeks to cash out. In order to accommodate both partners, the partnership frequently distributes undivided

interests in the Relinquished Property to them prior to close of escrow. Then, the Selling Partner "sells" his undivided interest to the buyer while the Exchanging Partner "exchanges" his undivided interest for Replacement Property. In theory, there should be no problem with a distribution followed by an exchange. After all, a distribution of property from a partnership is generally not a taxable event and there is no prohibition against the exchange of an undivided interest in the Relinquished Property for outright ownership of the Replacement Property. Nonetheless, in one published ruling, the IRS disallowed an exchange which followed a distribution from a wholly owned corporation. The courts, however, have split on this issue. One Partner Exchange of this type was approved both by the Tax Court and by the Ninth Circuit Court of Appeals. In that case ("Bolker"), a corporation distributed the Relinquished Property to its sole shareholder who then exchanged it for the Replacement Property. The IRS contended that the taxpayer never held the Relinquished Property for a proper purpose, namely, "for investment or in a trade or business." The court, however, decided that since the taxpayer never intended "to liquidate the investment or use it for personal pursuits," he held the Relinquished Property for a proper purpose.

In another case, however, the IRS successfully attacked an exchange which followed a distribution of the property from a partnership. In that case ("Chase"), a limited partnership signed a contract for the sale of a large apartment complex which it owned (the "Property"). Prior to close of escrow on the sale of that property, however, the partnership distributed to one of its general partners an undivided common interest in the Property. The general partner then attempted to

exchange that interest in the Property for Replacement Property which he selected.

The transaction was disallowed by the IRS and the Tax Court upheld that disallowance. The reason was that the purported exchange was treated and accounted for by all the parties and by the escrow holder as a sale. In particular, the deed from the Partnership to the general partner was held by him, unrecorded, for six months until shortly prior to close of escrow. Furthermore, the general partner apparently did not notify anyone of his supposed interest in the Property nor did he negotiate with the buyer on his own behalf. In addition, the general partner was not credited with any of the income or charged with any of the expenses of the Property for the period of his supposed ownership. Finally, the portion of the net sales proceeds distributed to the general partner was the amount he was entitled to receive under the partnership agreement rather than corresponding to his supposed interest in the Property.

The ABA Report addresses this issue and recommends adoption of a rule that the qualified use of property by a partnership should be attributed to its distributee partner. 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 ... distribu-tee/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 alternate structuring to accommodate both an Exchanging Partner and a Selling Partner in a partnership dissolution: the partnership exchanges the Relinquished Property for the Replacement Property, then distributes the Replacement Property to the Exchanging Partner and cash to the Selling Partner.

The Tax Court has approved an exchange structured in this way. In that case ("Maloney"), a corporation exchanged the Relinquished Property for the Replacement Property and then distributed the Replacement Property to its shareholders. The IRS contended that the exchange was impermissible because the corporation never intended to retain the Replacement Property for business or investment purposes but acquired the Replacement Property only to distribute to its shareholders. However, the Tax Court ruled in favor of the taxpayer, determining that the corporation held the Replacement Property for investment notwithstanding its subsequent transfer of the Replacement Property to the shareholders.

The report made by members of the American Bar Association Tax Section (the "ABA Report") deals with this type of Partner Exchange, as well. It advocates allowing attribution of the qualified use of the partnership of the Relinquished Property to its holding of the Replacement Property, notwithstanding the partnership's subsequent distribution of the Replacement Property to a partner.

Exchange Followed by Contribution

Frequently, an individual wishes to exchange the Relinquished Property for a Replacement Property which he intends to contribute to a partnership. The IRS has challenged such exchanges in the past. For example, in one revenue ruling, the IRS disallowed such an exchange on the ground that the taxpayer did not hold the Replacement Property for a "qualified use." However, such an exchange has been approved by the Tax Court and by the Ninth Circuit Court of Appeals. In that case ("Magneson"), the IRS contended that the Replacement Property was not held by the taxpayer for investment or in a trade or business. Nonetheless, both courts approved the exchange because, "...the new property is substantially a continuation of the old investment still unliquidated."

The ABA Report deals with this issue by urging the IRS to allow the attribution of the partner's qualified use of the Relinquished Property to his ownership of the Replacement Property, as well, even though the taxpayer subsequently contributes the Replacement Property to a partnership.

Partnership Taxation Issues

The ABA Report also makes several proposals regarding the interplay of I.R.C. section 1031 and the partnership taxation rules, which, in themselves, are extremely complex. Although a detailed explanation of these proposals is beyond the scope of this article, everyone involved in exchanges should be aware that these rules raise questions which can affect exchanges. The first issue is whether the transfer of an interest in a partnership, which already has transferred its Relinquished Property but has not yet acquired its Replacement Property, should preclude completion of the exchange. This issue arises because a "technical termination" of a partnership occurs whenever at least 50% of the interests in its capital or profits are sold. When there is a technical termination of a partnership, its assets are deemed to be contributed to a new partnership, the interests in which immediately are distributed to the remaining partners. The precise question, therefore, is whether the acquisition of Replacement Property by the "new" partnership should be considered a completion of the exchange by the "old" partnership. The ABA Report argues that the answer should be "yes," because the applicable Treasury regulation has been applied in similar circumstances to prevent technical terminations from causing artificial adverse effects. The next partnership issue involves the "special allocation" rules. An allocation of taxable income or loss agreed upon by the partners is permissible only if the allocation has "substantial economic effect." The ABA Report asks whether it is permissible for partners to specially allocate gain recognized in an exchange to a partner who does not wish to participate in the exchange and whose interest in the partnership is about to be liquidated. After analyzing this issue in two different ways, the ABA Report demonstrates that such an allocation is proper. In a like vein, the ABA Report addresses the issue of how gain recognized in an exchange should be allocated among the partners when the Relinquished Property originally was contributed by one of the partners and has "pre-contribution" gain.

The last partnership issue addressed by the ABA Report concerns the reduction of liabilities resulting from the partnership's sale of the Relinquished Property. Ordinarily, when a partnership sells encumbered property, the resulting relief of indebtedness results in a constructive distribution of money to the partners. The question here is whether, when an exchange straddles two tax years, the constructive distribution should be deemed to occur at the end of the first tax year or only after acquisition by the partnership of the Replacement Property and the concomitant increase in the debt of the partnership in the second tax year. Not surprisingly, the ABA Report concludes that a deferred exchange should be treated as a single transaction and that the temporary reduction of debt should not result in a constructive distribution of money.

Analysis

For several reasons, the tide seems to be shifting in favor of Partner Exchanges. First, although the court in Chase disallowed a Partner Exchange, in Bolker, Magneson and Maloney, the Tax Court and the Ninth Circuit Court of Appeals approved different Partner Exchange structurings. Second, the IRS itself seems to be changing. Not only has it recently taken an extremely liberal position with regard to reverse exchanges, there have been few if any recent adverse rulings regarding Partner Exchanges. Third, since Recommendations from members of the ABA Section of Taxation have been given careful consideration by the IRS in the past, it is not unlikely that the ABA Report will be treated similarly. Nonetheless, Partner Exchanges are not assured of favorable tax treatment. For one thing, the IRS did not acquiesce in Bolker, Magneson or Maloney. In addition, in each of these cases, the IRS inexplicably failed to challenge the Partner Exchanges as "step transactions." It is possible that a future court could decide that the steps involved in Partner Exchanges (i.e., the distribution from or contribution to a partnership and the exchange itself) actually amount to the exchange of a partnership interest for real property.

There are other risks attendant to Partner Exchanges. For example, the facts in both Magneson and Bolker arose prior to the 1984 amendment to I.R.C. section 1031 prohibiting exchanges of partnership interests. Furthermore, the "related party" rules might be applied to cause the taxpayer's gain to be recognized. Under these rules, if the taxpayer

exchanges with a related party, the taxpayer's gain becomes taxable if, within two years thereafter, either the taxpayer disposes of the Replacement Property or the related party disposes of the Relinquished Property. Although Congress almost certainly did not intend the related party rules to apply to these types of transaction, it is not impossible that the IRS could contend that the true substance of any of the exchange structuring discussed in this article constitutes an exchange between the partner and the partnership. Although risk cannot be eliminated at this time from Partner Exchanges, the likelihood of success will be substantially enhanced if the transactions have true economic substance. In a distribution followed by exchange, for example, the following steps should be taken:

- The deed from the partnership to the exchanger should be executed as early as possible, preferably before the partnership even begins to negotiate with the buyer of the property, and it should not be held unrecorded for a substantial period of time.
- For both tax and economic purposes, the exchanger should be treated as a true owner of the property distributed, being credited and charged with his pro rata portion of income and expenses of the property.
- The exchanger should sign the purchase agreement on his own behalf and all documents should clearly indicate that he is the owner of the property distributed to him and is negotiating on his own behalf.
- The portion of the net sale proceeds paid to the exchanger (or, more precisely, to his exchange intermediary), should be consistent with his undivided ownership interest.

Conclusion

Although we do not know how Congress, the courts and the IRS ultimately will resolve the outstanding issues regarding Partner Exchanges, I read the tea leaves to say:
"Proceed, but use caution and good common sense."

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