

CASE STUDY 1

PARTNERSHIP ISSUES AND SECTION 1031



A partnership can exchange property held for investment or for use in a trade or business provided the taxpaying entity is the same on both sides of the transaction. Complexities arise when some partners want to exchange their interests and other want to sell for cash. Exchanges of partnership interests are specifically excluded under IRC Section 1031(a)(2)(D). Consider the following example:

Tom, Elizabeth and Jacob own investment property together in TEJ Holdings, LLC, a tax partnership. Each year, the partners receive k-1s from their tax preparer showing their proportionate share of income and deductions.

TEJ Holdings, LLC signs a contract to sell its property to Golden Enterprises. Elizabeth and Jacob are interested in exchanging their interests in a tax-deferred manner. Tom wants to take his cash. What is the best way to structure the transaction to achieve all parties' objectives?

Drop and Swap

The Structure: The partnership terminates and distributes tenancy in common interests to the three owners. After some period of time, the co-tenants sell their respective interests. Elizabeth and Jacob exchange into separate replacement properties and Tom sells for cash.

The Issues: The partnership holding period generally will not tack to the individuals once they become co-tenants. Elizabeth and Jacob now need to consider whether their interests in the property have been held for investment or for use in their trade or business, or whether their interests have been held primarily for sale. How quickly after the drop out of the partnership can they sell or exchange their interests?

Will the former partners act like co-tenants prior to selling the property? The co-tenancy could be re-characterized as a partnership based on the business activity of the co-owners. The co-owners should give careful consideration to this issue and seek legal and tax advice.

If the contract for the sale of the property has been signed by the partnership prior to the partnership termination, the partners may have a step transaction doctrine issue.

Swap and Drop

The Structure: The partnership sells relinquished property and acquires one replacement property in a tax-deferred exchange under IRC Section 1031 and receives some cash boot from the exchange. Sometime after the exchange is completed, the partnership terminates and distributes the replacement property to Elizabeth and Jacob as co-tenants. The partnership also distributes the cash boot to Tom in redemption of his partnership interest.

The Issues: Have Elizabeth and Jacob held their interests in the replacement property for investment? Can the gain on the cash boot be specially allocated to Tom? The partnership rules are complex and require further analysis by the Taxpayers' advisors.

Ideally, TEJ Holdings, LLC will engage their tax advisor in their decision making process prior to entering into an agreement for sale. With proper planning, the goals of all of the partners should be achievable.