

PARTNERSHIPS AND §1031 EXCHANGES

"WHAT HAPPENS WHEN ONLY ONE PARTNER WANTS TO EXCHANGE?"



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A partnership may exchange property for other property of "like-kind." However, IRC Section 1031(a)(2)(D) specifically prohibits exchanges of partnership interests. This means that a taxpayer cannot buy into or sell interests in a partnership and qualify for a §1031 exchange. The rationale is that at a partnership interest [along with other assets such as shares in a real estate investment trust (REIT)] itself is personal property and thus is not "like-kind" with real property. Given these facts, what alternatives are available to taxpayers?

One option, referred to as a "swap and drop" variation, is that the entire partnership stays intact and at the entity level exchanges the relinquished property for replacement property. After the partnership closes on the replacement property purchase, the partnership can be liquidated or property refinanced and proceeds are distributed to the partners who desire cash. Another alternative, referred to as a "drop and swap" variation, is the partnership makes a valid election out of subchapter K under IRC §761. The partners seeking to cash out sell their undivided interests and the other partners exchange their tenancy-in-common interests for a replacement property.

ADDITIONAL CONSIDERATIONS

- Advance planning is important, as the greater the period of time between the election out of the partnership and the exchange, the better. The election out of the partnership to the individual partners as an undivided interest shortly before closing on the relinquished property leaves open the possibility the exchange could be invalidated because the property was not held as an undivided interest long enough to be considered "held for investment."
- The IRS U.S. Return of Partnership Income [form 1065](#) used to report income and losses by partnerships requires taxpayers to disclose whether the partnership (1) distributed any property received in a like-kind exchange, or contributed such property to another entity, or (2) distributed to any partner a tenancy-in-common or other undivided interest in partnership property. The IRS has generally taken the position that if property relinquished or received in an exchange is either distributed out of a partnership to a former partner or contributed by a partner to a partnership near the time of the exchange, the transaction does not qualify for nonrecognition treatment under §1031. The theory from the IRS's perspective in this situation is that the property is not 'held for investment or productive use in a trade or business' which is required by IRC §1031. The IRS's theory has been challenged successfully in the courts and previously there were indications the IRS might no longer be pursuing this issue. The 2008 tax return disclosure requirements indicate that the IRS may be more closely scrutinizing "drop-and-swap" and "swap-and-drop" transactions. The proposed changes are as follows: *Question 13:* Check this box if, during the current or prior tax year, the partnership distributed any property received in a like-kind exchange or contributed such property to another entity (including a disregarded entity). The objective of this question is to determine whether a partnership has accomplished an exchange and distributed the property to its partners or contributed the property to another entity, including disregarded entities. *Question 14:* At any time during the tax year, did the partnership distribute to any partner a tenancy-in-common or other undivided interest in partnership property? This question seeks to determine whether a partnership has distributed a tenant-in-common interest in the property to one or more partners in a partial or complete liquidation of that partner's interest.

- Every taxpayer should always consult with their legal and/or tax advisors to review the many issues and risks involved with partnership situations.



ASSET PRESERVATION
INCORPORATED

A National IRC §1031 "Qualified Intermediary"

National Headquarters

800-282-1031

Eastern Region Office

866-394-1031

apiexchange.com

info@apiexchange.com

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