DISPOSITIONS OF PARTNERSHIP PROPERTY

Whenever more than one person or married couple owns real estate, there is a potential problem for the exchange.

Often not all of the co-owners wish to exchange into the same property. Some co-owners may want to cash out of the investment, while other co-owners may want to acquire their own separate property through an exchange.

As long as the property is owned by the co-owners in their own right **and not as a partnership**, each of the co-owners can pursue their own investment goals (i.e., separately sell or exchange) without jeopardizing their co-owners' goals.

If, however, the Relinquished Property is either owned by a partnership or the IRS can assert the property was owned by a partnership, what each co-owner does becomes critical.

The IRS will not allow a co-owner to exchange a partnership interest for real estate.

Congress' 1984 amendments to Section 1031 specifically exclude the exchange of partnership interests. Many commentators suggest that Congress intended to stop the exchanging of "burned-out" tax-shelter limited-partnership interests. Unfortunately, the broad language of the amendments prevents the exchange of ANY partnership interest (General or Limited) for interests in real estate.

The Final Regulations for Deferred Exchanges further underscore the fact that the exchange of partnership interests are excluded under Section 1031.

There are four areas to review to determine if there may be disposition-of-partnership-property problem.

Title to the Property — Is title to the property in a partnership or in co-owner's individuals' names?

Partnership Agreement — Is there a partnership agreement, or other ownership or operating agreement which might be deemed a partnership agreement?

Partnership Tax Returns — Is there a partnership tax return?

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Partnership-like activities — Are there partnership-like activities? If the ownership of the property surrendered by the co-owners requires extensive business or management functions by the co-owners, the IRS can successfully assert that a partnership exists regardless of whether the above tests are not failed. The IRS argument hinges on the fact that the regulations define a partnership as joint undertakings if the participants carry on as a trade, business, financial operation or venture and divide the profits therefrom. An example in the regulations holds that a partnership exists where co-owners of an apartment building lease space and, in addition, provide extraordinary services to the occupants such as "valet parking."

If yes is answered to any of the above questions, there is a potential partnership problem.

What are the options if there is a potential partnership problem?

1. The partnership, as an entity, can always dispose of the Relinquished Property and the partnership, as an entity, can acquire the Replacement Property. Any taxpayer, including a partnership may exchange real estate for real estate.

If not all of the partners wish to participate in the exchange, there is a problem. The partnership could be prevented from disposing of the Relinquished Property and acquiring the Replacement Property as an entity.

2. It may be desirable to buy out the non-exchanging partner's interest in the partnership either prior to the disposition of the Relinquished Property or following acquisition of the Replacement Property, if the non-exchanging partner is willing to wait for his or her share of the sale proceeds. The partnership could then complete the exchange as an entity. There is a potential concern if more than fifty percent (50%) of the partnership units are sold because that would trigger a dissolution (followed by an immediate reconstitution) of the partnership for tax purposes. In other words, a different taxpayer could be holding the property.

3. The partnership may want to consider dissolving the partnership (**prior** to listing the Relinquished Property for sale and prior to entering into a Purchase and Sale Agreement) and distributing interests in the Relinquished Property to the partners in proportion to their partnership interests. 1990 Amendments to Code Section 1031 allow the partnership to opt out of partnership tax treatment by filing a Section 761 election, as long as they actually operate and manage the property as joint owners. The IRS may characterize the acquisition of the property interest from the partnership as ineligible for an exchange! The IRS may argue that the property interest just received from the partnership breakup was not held for investment purposes because it was immediately disposed of to acquire the Replacement Property. A Technical Advice Memorandum issued several years ago suggests the IRS may acquiesce to dissolutions which occur prior to entry into the sale agreement.

The former partners may then use their newly acquired undivided real property interests for individual exchange purposes or for outright sale depending on their wishes.

In dissolving the partnership, all of the partnership's property must be distributed in the dissolution. If the partnership owns more than one property, dissolution may not be feasible.

In addition, Revisions to Code Section 704 may make the distribution of the property to the partners in the breakup a taxable event for one or more of the partners.

In the case where there is more than just the Relinquished Property in the partnership, the exchanging partners might receive an undivided interest in the Relinquished Property in partial or complete dissolution of their partnership interests. In this circumstance, the IRS might still argue that the just-received property interest was not held for investment. Concerns about Code Section 704 would still have to be addressed.

4. Another possible solution is to have the partnership, as an entity, dispose of the Relinquished Property, but distribute cash or other non-qualified property to the non-exchanging partners.

Because the partnership, as an entity, disposed of the Relinquished Property, the cash or other non-qualified property which has been received by the non-exchanging partners would be normally taxable to the partnership and not be eligible for the exchange. However, the non-exchanging partners can make a special election which will result in the non-exchanging partners being taxed rather than the partnership. The partnership, as an entity, could then complete the exchange. It is not clear whether such a special election works in the context of an exchange; the election requires "substantial economic effect" (or substance).

The most common approach is to dissolve the partnership and distribute Relinquished Property to the partners. Ideally, the following steps need to be taken before the Relinquished Property is listed for sale:

Step 1 — Formally terminate any partnership agreement and replace it with a bona fide tenancy-in-common agreement;

Step 2 — Have the partnership's CPA file a final partnership tax return and elect out of partnership tax treatment;

Step 3 — Have the partnership deed the property to the individual partners in undivided interests proportionate to their partnership interest. (This deed is exempt from excise tax in Washington state and may be exempt from transfer taxes in other jurisdictions.)

Step 4 — Have the individuals enter into the listing and sale agreements for the Relinquished Property, to enable them to separately sell or exchange, as the case may be.

The more time that elapses between dissolution and ultimate exchange, the less likely the IRS will challenge the exchange. Dissolution and sale in separate tax years is desirable.

It is critical that the taxpayer (former partner) retain individual ownership of the Replacement Property for a substantial period of time. In addition, in order to not have the partnership problem both "coming and going," the taxpayer should not form a partnership to own the Replacement Property shortly after the exchange is completed. The taxpayer should not immediately contribute the Replacement Property to a partnership.

It is best, whenever possible, for each Exchangor (former partner) to acquire a 100 percent interest in a Replacement Property.

If joint ownership is involved in the acquisition of the Replacement Property, care must be taken to step up the ownership of the Replacement Property as a tenancy-in-common.

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