

# Partnership, LLC, and REIT Issues

## Partnership Issues

In general, exchanges of partnership **interests** are ineligible for non-recognition treatment under IRC §1031(a)(2)(D), as enacted in the Tax Reform Act of 1984. The Code specifically states that §1031(a)(1) does not apply to an exchange of interests in a partnership regardless of whether the interests exchanged are general or limited partnership interests or are interests in the same partnership or in different partnerships. As a result, a taxpayer cannot exchange an interest in *ABC Partnership* for an interest in *XYZ Partnership*, even if both partnerships own the same kind of property. It is also important to note that a partnership interest is personal property, which is not like-kind to real property owned by a partnership.

A partnership, however, may exchange **real property** with any other entity in a transaction qualifying under §1031, as long as the partnership meets the requirements that apply to all exchange transactions (i.e., both the relinquished and replacement properties will be held for investment or business purposes).

A key issue when addressing exchanges involving partnerships is to first determine the investment objectives of the individual partners in the partnership. When the *entire partnership* wants to structure a tax deferred exchange, it is clear that the transaction can qualify under §1031. Problems arise, however, when one or more of the individual partners have different investment objectives.

The most commonly asked question is **“Can a valid exchange still be structured if one of the partners drops out of the partnership?”** Often one or more of the partners desire to withdraw from the partnership and receive cash or other property in return for their partnership interest.

Although there are many structures, conservative practitioners believe that there is less risk of an exchange being disallowed on audit if the parties desiring to receive cash on the sale of the relinquished property receive a distribution of their partnership interest in the form of an undivided interest in the relinquished property prior to the closing of the sale. Then, as long as there are still at least two remaining partners, this leaves the partnership alive to accomplish the exchange. At the closing, the surviving partnership and each of the former partners convey their respective interests in the relinquished property, with the former partners receiving cash, and the Qualified Intermediary receiving the net proceeds due the partnership to enable the partnership to complete the exchange when it locates replacement property. Completing the redemption of the cashing-out partner as far in advance of the sale, and if possible, prior to the execution of the contract of sale for the relinquished property, is highly desirable.

Other possible solutions are to liquidate the partnership either prior to or after the exchange and distribute to each “partner” a tenancy-in-common interest in the real property with the other former partners. While there are no recent cases directly on point, it is advisable to transfer ownership to the individual Exchangers as far in advance of the exchange as possible. If a distribution or dissolution occurs shortly prior to the sale, the key issue is whether the relinquished property was “held for productive use in a trade or business or for investment purposes.” This “qualified use” requirement must be met for any exchange. The strategy of distributing to the “cash-out” partners prior to sale, thus allowing the partnership to accomplish the exchange, may avoid the qualified use issue.

The Tax Court seems to utilize the *substance-over-form doctrine* in situations like these. In *Bolker v. Commissioner*, 81 TC 782 (1983), aff'd 760 F2d 1039 (9th Cir. 1985), the individual taxpayer entered into an exchange agreement for his relinquished property on the same day that he received a liquidating distribution of the property from his wholly-owned corporation. He then acquired a replacement property three months later to complete his exchange. The Tax Court held that the qualified use requirement is met as long as the taxpayer does not intend to liquidate the relinquished property or use it for personal pursuits.

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## Brief Exchanges

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## Partnership, LLC, and REIT Issues *(Continued)*

In *Maloney v. Commissioner*, 93 TC 89 (1989), a corporation exchanged real property and, at the time of the exchange, had the specific intent to liquidate and distribute the replacement property to its shareholders. One month after completing the exchange, the corporation liquidated under former IRC §333, distributing the replacement property to its shareholders. The Court upheld the validity of the exchange, holding that even though there was a change in ownership, the continuity of investment satisfied the qualified use requirement.

Although *Bolker* and *Maloney* both involve corporations, the argument that the taxpayer is merely continuing its investment in another form is equally logical in the partnership context, given the aggregate nature of a partnership.

See also *Magneson v. C.I.R.*, 753 F.2d 1490 (9th Cir.1985), where the courts allowed tax deferred exchange treatment based on the holding that contribution to or from a partnership is an allowable change in the form of ownership rather than a disposition that would disqualify the property from exchange treatment. Also, see *Chase v. C.I.R.*, 92 T.C.53 (1989), which is instructive on the elements to avoid when attempting to dissolve a partnership prior to an exchange, such as the Exchangers' failure to negotiate on behalf of themselves as individuals, their failure to pay their respective portion of the broker's fees, and the fact that in apportioning the net sales proceeds, the Exchangers were treated as partners rather than as direct owners.

As a result, if properly structured, it appears that a valid tax deferred exchange can occur as long as the Exchangers do not "cash-out" their investment. However, a prudent Exchanger must plan carefully. Failing to properly liquidate a partnership interest prior to an exchange can lead to a taxable event. Transactions of this type can be complicated and should be carefully reviewed by tax and legal counsel to determine whether the facts and circumstances are strong enough to support a defensible tax deferred exchange.

The strategy of structuring an exchange of property owned by a partnership where all partners do not want to exchange has become somewhat more problematic as a result of an amendment to Form 1065 (the partnership income tax reporting form), which has added new exchange-related questions for returns filed for tax years ending on or after December 31, 2008. Form 1065 now asks 1) if an exchange was done and whether any property acquired was distributed to partners, and 2) if any partnership property was distributed to partners in co-tenancy or other joint ownership. These actions are not illegal, but the fact that the Service is gathering this information raises a potential concern. Moreover, with the "more likely than not" standard of IRC §6694 required of tax return preparers to avoid penalty for positions taken, the client's tax preparers must be brought into the planning of these transactions at the very beginning of structuring the exchange.

### LLC Issues

Alternate forms of ownership of the replacement property, required by a lender demanding a bankruptcy remote entity, are now generally less problematic than the above partnership scenario. The most common form of ownership in a new entity is the single member limited liability company ("single member LLC"). In addition to a single member LLC, there are other so called "pass-through" entities (which are disregarded by the IRS as entities separate from the taxpayer), such as a Delaware business trust, a Massachusetts nominee trust, an Illinois land trust, and grantor trusts. Other examples, such as subsidiaries of corporations, or new corporations formed by mergers or acquisitions of other corporations, can also provide for different parties on each side of an exchange.

In the case of single member LLCs, the initial question has always been whether taking title in the name of the new LLC would be characterized as a partnership or beneficial interest, therefore falling under one of the exclusions enumerated in IRC §1031(a)(2). One exception to the general rule that the same taxpayer entity that sells the relinquished property has to purchase the replacement property is found in Treas. Reg. §301.7701-(3)(b)(1), which allows "single-member LLCs" that acquire property to be ignored for tax purposes and to be treated as the direct owners of the property. Not all states allow single member LLCs, so the Exchanger should consult with legal counsel to determine if the Exchanger's state will allow the use of a single member LLC. The use of single member LLCs allows an individual or entity to sell property to start an exchange and complete the exchange by purchasing the replacement property in the name of the single member LLC.

In general, an entity with only one owner will be classified either as a disregarded entity, or a corporation, whereas an entity with two or more members will be classified as a partnership or a corporation. One exception to this rule is that the IRS will recognize an LLC as a disregarded entity if it is owned solely by a husband and wife as community property under the laws of a state. Rev. Proc. 2002-69. Accordingly, an entity with only one member, which does not elect to be treated as a corporation, will be treated as a disregarded entity.

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## Partnership, LLC, and REIT Issues *(Continued)*

This allows an Exchanger to take title in a new entity, fulfilling a lender's requirement, without jeopardizing the viability of the exchange. A classification change can be accomplished by an eligible entity by filing Form 8832. A classification change, which remains effective for 60 days, can be made up to 75 days prior to or 12 months after the date upon which the election is filed.

Private Letter Rulings are instructive regarding the flexibility afforded by single member LLCs. The IRS has approved of replacement property acquired by a 2 member LLC in which the Exchanger and the Exchanger's wholly-owned corporation were the members of the LLC. At the behest of the lender, the lender's representative sat on the Board of the Exchanger's corporation, which was formed and made a member of the LLC solely to prevent the Exchanger from placing the LLC into bankruptcy. The IRS acknowledged that the Exchanger's corporation had no rights or risk regarding profits, losses, or management of the LLC, and agreed to disregard the 2 member LLC as an entity separate from the Exchanger similar to the treatment of a single member LLC. PLR 199911033. An Exchanger was permitted to acquire replacement real property by assignment of the sole membership interest in the seller's single member LLC, rather than by deed. PLR 200118023. An Exchanger who acquired the replacement property in its own name was allowed to deed it into a single member LLC in which the Exchanger was the sole member, without violating the "held for" requirement. PLR 200131014. In a very complicated ruling (PLR 200807005), the IRS permitted a limited partnership Exchanger to purchase all of the partnership interests of the seller of the replacement property, and to hold title to the replacement property in the partnership, the partners of which were Exchanger and a new single member LLC owned by Exchanger. Since the Exchanger was the sole member of the new LLC and the sole partner, the IRS ruled that the partnership had only 1 true owner, and thus would be disregarded as an entity separate from the Exchanger.

As LLCs become increasingly popular as a means for investors to own real estate, the same questions arise for LLCs and their members as with partnerships. There is little authority regarding LLCs and exchanges, but most tax analysts agree that, assuming the LLC is treated as an association, the same principles apply. If the LLC were going to do an exchange, it would be prudent for the same members to sign the replacement property Identification Notice as would be necessary to bind the LLC in any other matter. See Example 5 in Treas. Reg. §1.1031(k)-1(j)(3), which shows that liabilities on the relinquished property may be netted against liabilities on the replacement property. Therefore, it seems likely that the "liability gap" issues under IRC §752 will not cause recognized gain for LLC members, or partnership partners, because of an exchange. The "at risk" rules of IRC §465 may apply to the LLC's members', or partners', detriment if the replacement property is not considered an "aggregation" of the relinquished property.

### REIT Issues

Another type of problem arises when an Exchanger exchanges into or out of an interest in a Real Estate Investment Trust ("REIT"). Generally an interest in a REIT will be considered a security, and thus fall into the exclusions enumerated in IRC §1031(a)(2). However, if structured properly, there are alternatives for Exchangers wishing to do these types of exchanges. An owner of real property can contribute real property to an "UPREIT" or "DOWNREIT" pursuant to IRC §721, which also is a tax deferral provision. However, many times a REIT is not interested in property currently owned by the Exchanger, but wishes the Exchanger to exchange into new property under §1031 that the REIT identifies, and then has the Exchanger contribute that new property into the REIT. The issue with this structure is whether the Exchanger will be deemed to have held the property for business use or investment purposes, or to have held the property only for resale to the REIT. See IRC §1031(a).

As an alternative to contributing newly acquired replacement property to an UPREIT, the Exchanger may be given a right to place the property with the UPREIT subject to a "call" after a year or more, in exchange for REIT units. In order to avoid the potential argument that these are steps in an integrated whole under the so called "step transaction doctrine", the Exchanger should not have a "put" of his interest to the UPREIT. A "call" should not have this same risk since the decision to complete the transaction is in the hands of the UPREIT and not the Exchanger. One of the concerns is whether this option will run afoul of the rules expressed in *Magneson v. C.I.R.*, 753 F.2d 1490 (1985). In *Magneson*, a taxpayer exchanged into replacement real property, and thereafter immediately contributed that property to a partnership, in exchange for a general partnership interest. The Court ruled that the taxpayer in *Magneson* did not hold the property for business or investment purposes pursuant to IRC §1031(a). The structure of the "call" gives the Exchanger and the UPREIT the right, but not the obligation, to complete the placement of the real property into the UPREIT. Although this is a very general overview of structuring an exchange of property into an UPREIT, it would appear that a transaction of this type is a viable alternative to realizing a capital gain tax for Exchangers desiring to "exchange into" a REIT.

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