

PARTNERSHIPS AND 1031 EXCHANGES

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



Compliments of

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 an Exchanger cannot buy into or sell interests in a partnership and qualify for a §1031 exchange. The rationale is that a partnership interest [along with a real estate investment trust (REIT) share] itself is personal property and thus is not "like-kind" with real property. Given these facts, what alternatives are available to Exchangers?

IS IT A 'TRUE' PARTNERSHIP?

First, investors owning a property together must determine if they really own the property in a true "partnership." Often, investors who own property with others may consider the other individuals their "partners" even though they hold title as an undivided interest and don't file a partnership tax return, thus they are merely "co-owners." The test is generally, "do the owners hold title as "tenants-in-common?"

POTENTIAL ALTERNATIVES

One option is that the entire partnership stays intact and exchanges the relinquished property for a replacement property. After the partnership closes on the replacement property, the property can be refinanced and the proceeds are distributed to the partner who wants to cash out.

Another alternative is that the partnership has a valid election out of subchapter K under IRC §761. The partner seeking to cash out sells their undivided interest and the other partner exchanges their tenancy-in-common interest for a replacement property. (Note: There are risks associated with partnership issues that must be discussed with a legal and/or tax advisor.)

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 individuals as an undivided interest shortly before closing on the relinquished property leaves open the possibility that the exchange would be invalidated because the property was not held as an undivided interest long enough to be considered "held for investment." [Note: In several instances, however, the Tax Court has extended §1031 tax deferral to former partners who changed their ownership structure prior to closing on a relinquished property.]
- If the entire partnership will be exchanging, it is preferable that the Partnership Agreement mention that they are holding the property "for investment or use in a trade or business."
- Every Exchanger should always consult with their legal and/or tax advisors to review the many issues and risks involved with partnership situations. Contact Asset Preservation toll-free to discuss partnership issues in greater detail.



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