Partnerships & 1031 Exchanges

by Greg Lehrmann, Attorney

Big Picture

Like any taxpayer, a partnership (including a limited liability company taxed as a partnership) can engage in a like-kind exchange under IRC Section 1031 to defer paying tax on capital gains. Difficulties may arise, however, when the individual partners desire different outcomes with regard to the sale of property. Some partners may wish for the partnership to stay together upon sale and do an exchange; others may want to partition and do their own exchange with their portion of the property; still others may want to receive cash and simply pay the tax. What alternatives are available to the partners?

Separate Exchanges

A taxpayer must own a capital asset to qualify for a 1031 exchange. The fact that a partnership owns a capital asset does not mean that any individual partner has an ownership interest in that asset. The partners merely own partnership interests, which are specifically excluded from Section 1031 under section 1031(a)(2)(D). Therefore, if an individual partner wants to do a 1031 exchange, the partner must convert his or her partnership interest into an interest in the capital asset owned by the partnership.

One method for accomplishing this, known as a “drop and swap,” involves the liquidation of a partnership interest by distributing an interest in the property owned by the partnership. After completion of the “drop,” the former partner will have converted his or her partnership interest into an interest in the actual property itself, as a tenant-in-common with the partnership. The property can then be sold, with the former partner and the partnership each entitled to do what they wish (sell or exchange) with their respective interests.

Related to the “drop and swap” is the “swap and drop.” This involves the same two steps, but in reverse order. The partnership completes the exchange (the “swap”), and then distributes an interest in the replacement property to the departing partner.

Intent to Hold Issues

Both the “drop and swap” and the “swap and drop” alternatives raise potential "intent to hold" issues. If the “drop” occurs close in time to the “swap” (or vice versa), there may be some question as to whether the relinquished property (or replacement property) was “held for investment.” If the drop appears too close in time to the swap, the partner’s exchange may be deemed an exchange by the partnership (rather than by the partner) under Commissioner v. Court Holding (Commissioner v. Court Holding Co., 324 U.S. 331, 65 S.Ct. 707 (1954). The more time that passes between the “drop” and the “swap,” the better.

A line of federal cases (Bolker v. Commissioner, 81 T.C. 782 (1983), affd. 760 F.2d 1039 (CA9 1985); Maloney v. Commissioner, 93 T.C. 89, 93 T.C. 9 (U.S.T.C. 1989); Mason v. Commissioner, T.C. Memo 1988-273 [June 27, 1988], aff'd 880 F. 2d 420 [11th Circuit 1989] provides taxpayer-friendly authority in response these types of challenges by the IRS. However, some state taxing authorities (notably, the California Franchise Tax Board) aggressively challenge exchanges, and argue that they are not bound by the federal cases. Also, changes made to the federal partnership tax return (IRS Form 1065) make it easier to detect when drop and swap transactions occur, thus making such transactions more vulnerable to challenge by taxing authorities.

Partner Cash-Out

In some instances, a majority of the partners may want the partnership to complete an exchange, while others may want to be "cashed out" upon sale of the relinquished property. One way to accomplish this is for the partnership to receive cash from the sale in an amount sufficient to purchase the departing partners' interests. The departing partners would pay taxes on all of their gain. The cash used for the pay-out would be "boot," requiring the partnership to allocate the resulting gain among all of the remaining partners.

A better alternative, known as a partnership installment note ("PIN") transaction, results in the gain associated with the "boot" being recognized only by the departing partners. In a PIN transaction, instead of receiving cash, the partnership receives an installment note in the amount necessary to cash out the departing partners. The note is transferred to the departing partners as consideration for their partnership interests. If at least one payment under the note is to be received in the year following the exchange, the gain associated with the note will be taxed under the Section 453 installment method, and recognized only when the actual payments are received by the departed partners.

Exchange Followed by Contribution

When an individual completes an exchange and contributes the replacement property to an entity, or when an entity exchanges property after receiving a contribution, an "intent to hold" issue could arise. Magneson v. _ involved an exchange by an individual, followed immediately by a contribution of the replacement property to a general partnership; the issue was resolved in the taxpayer's favor. Magneson provides useful authority against challenge by the IRS; the same logic was applied at the state level in Dep't of Revenue v. Marks, Or. Tax (Case No. TC 4797).

Election Under Section 761

Again, partnership interests are specifically excluded from the application of Section 1031. A very narrow exception applies to a partnership that has elected, under Section 761(a), not to be subject to the partnership taxation provisions of Subchapter K. This election applies only to a partnership: (i) for investment purposes only and not for the active conduct of business; (ii) where the partners hold title to the property as co-owners; (iii) where each owner reserves the right to separately take or dispose of his or her share of the property; and (iv) which has no active trade or business. If a partnership makes such an election, the partnership interest will be treated as an interest in the underlying assets, and can be exchanged under Section 1031.

About Us

Greg Lehrmann is the founding member of Excel 1031 Exchange with 42 years of experience in commercial and residential real estate. For the past three decades he has dedicated his career to 1031 exchange work and has handled tens of thousands of exchanges throughout the country.

Mr. Lehrmann is a distinguished attorney double board certified in commercial and residential real estate law by the Texas Board of Legal Specialization. Only 2% of attorneys in Texas meet this exacting standard. He has a B.B.A with honors in accounting from The University of Texas and a J.D. from The University of Texas School of Law.

Mr. Lehrmann and his wife, Texas Supreme Court Senior Justice Debra Lehrmann, have two sons, Gregory & Jonathan, practicing attorneys, and two beautiful grandchildren, Jack (age 4) and Haley (age 2).