OLD REPUBLIC EXCHANGE

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Partnership Distributions & 1031 Exchanges Minimize Risk with Advance Planning

THE PARTNERSHIP DILEMMA: A partnership owns real property that it intends to sell. Some partners want to use the proceeds to buy other property in a tax deferred exchange. Other partners wish to keep their cash and not buy anything.

The "Drop and Swap" is the often employed, high risk strategy utilized to resolve this partnership dilemma.
In this strategy, the partnership deeds a fractional tenant in common interest in the property to each of the partners in an interest equivalent to their partnership interest ("the drop"), allowing each of the partners to take their proceeds and either re-invest ("swap") or cash out.

THE RISKS:

- The partners may not meet the "qualified use" requirement – i.e. the requirement that property be held for investment, because the partners held the property briefly and only for the sole purpose of selling it.
- The transfer to the partners may be treated as a sale fol lowed by a liquidation of the partnership.
- The IRS could argue that the undivided interests represent partnership interests, which are excluded from tax deferral under § 1031.

ADVANCE PLANNING TIPS TO MINIMIZE THE RISK OF TIC BEING RE-CHARACTERIZED AS A PARTNERSHIP:

1. Deed to the partners as far as possible in advance of the exchange;
2. Create a formal tenancy in common arrangement/agree ment long before negotiating and consummating a sale of the property;
3. Elect under IRC § 761(a) not to be treated as a partnership for tax purposes;
4. Execute the purchase and sale contract as tenants in common;
5. Make sure the proceeds are distributed to the tenant in common owners;
6. Make sure TIC owners participate in all income and ex penses associated with the property; and
7. Consult with your tax professional well in advance of a proposed sale to determine if any of the above sugges tions are suitable for your situation.

TWO ALTERNATIVE STRATEGIES TO THE DROP AND SWAP RISK:

1. Partners wishing to exchange purchase the departing partner's partnership interests for cash andreconfigure the partnership to exclude the departing partner. The partner ship then proceeds with the exchange.

2. The partnership negotiates to sell the property, but requires the buyer to provide – as part of the purchase price – an installment note in an amount equivalent to the departing partner's(s') interest. Thereafter, the partnership assigns the note to the departing partner(s) before any payments are made.

Taxpayers should keep in mind that these types of transactions are inherently risky and are therefore often subject to scrutiny. As such, they can be re-characterized by the IRS under the step or substance over form doctrines as the sale of a partnership interest, which is precluded from tax deferral treatment under IRC § 1031. Taxpayers should therefore always consult their tax advisor well in advance of their contemplated transaction.

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