The Dilemma of Partnership "Divorce" in the Context of Tax-Deferred Like-Kind Exchanges

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Section 1031 of the Internal Revenue Code permits the deferral of income taxes otherwise due in connection with the sale of appreciated property where the proceeds are re-invested in the acquisition of "like-kind" property. The rationale for this beneficial tax result revolves around the idea that if the investor has not "cashed out" of the investment but instead continues an unbroken financial commitment to like-kind property, the investor has not locked in an economic gain or produced the requisite liquidity to pay income taxes.

In order to have a valid like-kind exchange involving real estate under Section 1031 of the Internal Revenue Code, a taxpayer must exchange an interest in real estate for another interest in real estate. Exchanges featuring partnership interests, even if those partnerships whose assets are substantially comprised of real properties, will not qualify for like-kind exchange treatment. Since a limited liability company is treated as if it were a partnership for tax purposes, these rules apply to LLC's as well as partnerships.

When a partnership disposes of its investment real property occasionally all of the partners will agree to re-invest their share of proceeds into the same new property. More often however, the initial "project" is considered complete on sale of the original investment property and the partners will each desire to make his or her own independent decision as to the use of his or her share of the proceeds. One may want to exchange into new property. Others may want to take proceeds in cash and pay the resulting income taxes.

When these decisions are executed inside the partnership, the partnership typically recognizes a portion of its taxable gain which is allocated to all of its various partners. The consequence is a partially taxable transaction to the partners otherwise desiring to effectuate a tax deferred, like-kind exchange.

There are a variety of ways to potentially accommodate the diverging goals of the Partners in a more tax-efficient manner.

- **TIC Strategy/Pre-Sale Redemption of Partners.** This strategy is the most commonly recognized approach for terminating the original partnership relationship and permitting some partners to complete a tax-deferred exchange. It contemplates the redemption of the partnership interest of a partner who does not wish to invest in (or who the other partners do not wish to include in) a replacement investment property. The "cash partner" will be redeemed out of the partnership in exchange for an undivided tenancy-in-common (TIC) interest in the property prior to its sale.

As a result, when the property is sold, there are two sellers: the partnership (whose remaining partners wish to exchange) and the redeemed partner with each conveying a tenancy-in-common interest to the buyer. The redeemed partner takes his share of sales proceeds and pays his tax. The partnership takes its share of sales proceeds and purchases replacement like-kind property.

The complications here include a vulnerability to attack by the IRS that the distribution to the cash partner should not be respected if it happens too close in time to a sale transaction, particularly where the partnership distributes an interest in the property after entering into a contract to sell the property. In addition, this transaction may trigger multiple transfer tax obligations and trigger a default under the partnership's mortgage financing.

Notwithstanding, this strategy is the preferred method of addressing the divergent goals of partners where the planning can be accomplished sufficiently in advance of sale.

- **Post-Exchange Redemption of Partners. In the alternative, p**artners who wish to receive cash for their proportionate interest in sale property can be redeemed out of the partnership after the exchange. Unfortunately this strategy will require the remaining partners to "trade-up" or add additional leverage to their investment in order to completely defer the taxable gain inherent in the sale property. In order to generate the cash necessary to redeem out the non-exchanging partner after closing, the new replacement property may be refinanced to produce the cash. As in the earlier strategy, sufficient time should be allowed to lapse between the sale and the refinancing to limit the possibility that the IRS will collapse the refinancing and the sale / exchange transaction into a single, partially tax-deferred, sale where the consideration is deemed to be part cash and part exchange property.

In the alternative, the exchanging partners could contribute new cash to the partnership to be used to redeem the non-exchanging partner.

- **Sale for Cash and Short-Term Installment Note.** If the sale of the old property can be structured to include a cash component (whether buyer's cash or proceeds of acquisition financing) in an amount sufficient to purchase the exchanging partners' equity and the partnership agrees to extend seller financing in an amount sufficient to represent the non-exchanging partner's interest, then the tax law provides that the partnership's taxable gain will be reported on the installment method (when the buyer's note is paid off). By distributing the installment note to the non-exchanging partner after closing but before the note is paid, all of the installment gain is reported by the redeemed partner.

Careful planning is required in advance and of course the non-exchanging partner has an added level of risk as it relates to the solvency of the buyer.

- **Multiple Exchanges within the Partnership.** If all partners wish to exchange, but into separate properties, the partnership can sell its old property and exchange into the several properties identified by the partners. Using this strategy, after the exchange the partnership would liquidate by distributing the various newly acquired properties to the appropriate individual partners.

Again, timing of the various transactions and careful advance planning is important. In addition, with this strategy, there is a period of time where all of the partners are at risk for the investment decisions of the other partners.