Partnership, LLC and REIT Issues

In general, exchanges of partnership **interests** are excluded from non-recognition treatment under IRC §1031(a)(2)(D), as enacted in the Tax Reform Act of 1984. The Code specifically states that Section 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* . 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 IRC §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 IRC §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 their exchange when they locate replacement property.

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 avoids the qualified use issue altogether.

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 (CA9 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.

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 the former IRC §333, distributing the replacement property to its shareholders. The Court held that even though there was a change in ownership, the continuity of investment satisfied the qualified use requirement and upheld the validity of the exchange.

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Partnership, LLC and REIT Issues *(continued)*

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 Exchanger's 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 taxpayer does not "cash-out" their investment. However, a prudent taxpayer 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 qualified tax and legal counsel to determine whether the facts and circumstances are strong enough to support a defensible tax deferred exchange.

LLC Issues

Alternate forms of ownership on the purchase side of a tax deferred exchange that may be required when a lender wishes to shield its security interest in the replacement property in 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 ("LLC"). In addition to a single member LLC, there are other so called "pass-through" entities which are disregarded by the IRS as a entity 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 limited liability companies, 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. Regs. §301.7701-(3)(b)(1) which allows "single-member LLC's" 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 LLC's so the taxpayer should consult with legal counsel to determine if the taxpayer's state will allow the use of a single member LLC. The use of single member LLC's allow 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 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. Accordingly, an entity with only one member, which does not elect to be treated as a corporation, will be treated as a disregarded entity. This allows a taxpayer to take title in a new entity, fulfilling a lender's requirement, without jeopardizing the viability of the exchange. Treas.Reg. §301.7701-2(c). A classification change can be accomplished by an eligible entity by filing Form 8832 – Entity Classification Election. Treas. Reg. §301.7701-3(c)(1)(i). A classification change can be effective up to 75 days prior to, or 12 months after the date upon which the election is filed. However, the entity may not make any additional classification elections within 60 months after the effective date of the previous classification election. Treas. Reg.§301.7701-3(c)(iv).

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Partnership, LLC and REIT Issues *(continued)*

Private Letter Rulings are instructive regarding the flexibility afforded by single member LLC's. The IRS has approved of replacement property acquired by a 2 member LLC in which the taxpayer and the taxpayer'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 taxpayer's corporation, which was formed, and made a member of the LLC, solely to prevent the taxpayer from placing the LLC into bankruptcy. The IRS acknowledged that the taxpayer'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 taxpayer similar to the treatment of a single member LLC. LTR 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. LTR 200118023. A taxpayer, who acquired the replacement property in its own name, was allowed to deed it into a single member LLC in which the taxpayer was the sole member, without violating the "held for" requirement. LTR 200131014

As LLC's become increasingly popular as a means for investors to own real estate the same questions arise for LLC's and their members as with Partnerships. There is little authority regarding LLC's 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 a taxpayer 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 taxpayers 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. However, many times a REIT is not interested in property currently owned by the taxpayer, but wishes the taxpayer to exchange into new property, which the REIT identifies, and then has the taxpayer contribute that new property into the REIT. The issue with this structure is whether that taxpayer will have been deemed to have held the property for business or investment purposes, or 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 taxpayer may be given a right to place the property with the UPREIT after a year or more as a "put", and the UPREIT will have the option, after a year or more to acquire the property, as a "call", in exchange for UPREIT units. Problematic to this structure is whether these options 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 *Magneson* did not hold the property for business or investment purposes pursuant to IRC §1031(a). In the instant case, the structure of the "put" and "call" give the taxpayer and the UPREIT the right, but not the obligation to complete the placement of the real property into the UPREIT. By structuring the transaction in this way, taxpayers can attempt to avoid the problems of *Magneson* by not contributing the real property immediately post-exchange. The IRS could view these steps as an integrated whole under the so called "step transaction doctrine", in which case the IRS would characterize the transaction complete upon the mutual "put" and "call" agreement, in violation of *Magneson*. However, since neither party is obligated to complete the transaction, it would seem to be difficult for the IRS to characterize the transaction in this way. 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 investors wishing to "exchange into" a REIT.

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