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Deals involving partnership interests in a 1031 exchange

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Congress passed Section 1031(a)(2)(D) in the Deficit Reduction Act of 1984. Among other things, the bill amended Section 1031 to exclude “any interest in a partnership” from the types of property otherwise eligible for deferral in an exchange transaction. Thus, holding real property in a partnership (or any entity treated as a partnership for federal income tax purposes) will generally limit the ability of an investor owner to sell the partnership interest as relinquished property in a 1031 exchange independent from the other owner partners. Similarly,

the partnership interest would not be marketable to a buyer desiring to obtain tax deferral under Section 1031. As a result of this statutory limitation, and for other reasons, the popularity of tenant in common ownership structures has increased dramatically in recent years. Nevertheless, desirable commercial real estate continues to be held in limited liability companies, limited partnerships and other entities that would be characterized under federal law as partnerships (hereinafter collectively “tax partnerships” and individually, “tax partnership”). Recent private letter rulings (PLR) issued under Section 1031 provide guidance concerning the characterization of a transfer of a partnership interests as a transfer of the real property owned by the

partnership in certain cases. A working knowledge of these rules is critical to attorneys and accountants advising real estate investors engaged in tax deferred exchanges.

Acquisition of a Tax Partnership

It is well settled that a partner in a tax partnership that owns real estate cannot sell their partnership interests as relinquished property in a tax deferred exchange. The sale of a partnership interest is always characterized as the transfer of a partnership interest under Section 1031(a)(2)(D), but the converse is not always true with respect to a purchase of partnership interests. PLR 200807005 provides that where an investor acquires 100% of the outstanding interests of a tax partnership that owns real property,

the investor will be treated for tax purposes as having acquired the real property owned by the tax partnership. Under the facts presented in PLR 200807005, an investor purchased 100% of the outstanding interests in a limited partnership. Immediately following the purchase, the investor owned all of the economic interests of the selling partners, including the interests of the general partner and all limited partners. Upon the acquisition of the partnership interests, the limited partnership would be characterized for federal income tax purposes as a disregarded entity in the hands of the investor. Citing Revenue Ruling 99-6, 1999-1 C.B. 432, the IRS characterized the transaction from the purchaser’s point of view as a dissolution of the limited partnership followed

by a deemed distribution of the partnership's assets to the selling partners. The purchaser would therefore be treated as acquiring the assets from the selling partners. The PLR notes that the sellers of the partnership are treated as transferring partnership interests.

To summarize the requirements discussed above, the purchase of a partnership interest will be treated as the acquisition of the property of the partnership for purposes of Section 1031(a) and not treated as a partnership interest under Section 1031(a)(2)(D) if the following requirements are met:

1. The selling entity must be characterized as a partnership in the hands of the selling partners for federal income tax purposes. Thus, a general partnership, limited partnership, limited liability company or limited liability partnership that would be treated as dissolved upon the transfer of 100% of the outstanding partnership interests to a single buyer. A corporation, association or any entity that elects to be taxed as a corporation would not satisfy this requirement.

2. The buyer must acquire all (100%) of the outstanding interests in the tax partnership. If even a small partnership interest is retained by a selling part-

ner, the transaction results in a tax partnership that survives the transaction. In that case, the purchasers have acquired partnership interest and not the real property owned by the partnership.

3. The purchased entity must be a "disregarded entity" in the hands of the buyer immediately following the purchase. Generally, an entity that would be treated as a partnership if owned by multiple partners is a disregarded entity if owned by one owner. For this reason, two or more buyers who collectively purchase 100% of the interests in a tax partnership would not be treated as having acquired the assets of the selling partners because the resulting entity would be characterized as a partnership and not a disregarded entity.

Partnership Consolidation and other Structures

Although the Letter Ruling discussed previously in this article involved an outside buyer acquiring 100% of the interests of a limited partnership, the same analysis should apply if an existing partner acquires the interests of all other partners in the tax partnership. In that event, the tax partnership would be deemed dissolved on the

transfer of the outstanding partnership interests to the acquiring partner and the selling partners would be treated as transferring their proportionate interests in the partnership's property to the acquiring partner.

Finally, Revenue Ruling 99-5 characterized a transfer of a portion of the member's interest in a single member limited liability disregarded entity (a disregarded entity) to a new incoming member as a transfer of a proportionate interest in property of the disregarded limited liability company to incoming member followed by a deemed contribution of the property to a new tax partnership among the seller and the incoming member. Thus, a transfer of a membership interest or other interest in a disregarded entity should be treated as the sale of an interest in the property of the disregarded entity to a buyer that would be eligible for tax deferral under Section 1031(a).

Other than the instances noted above, the purchase or sale of a partnership interest by a partner will not be treated as a disposition of the property of the tax partnership and will not qualify for tax deferral under Section 1031(a)(2)(D). Where the transfer of a partnership interest will present a problem, the

partners should consider other options that might be available well before a sale or purchase is contemplated. The partners may restructure the ownership structure in a manner that would permit an exchange such as by dissolving the partnership to convert ownership of partnership assets into a tenants in common form of ownership. The timing of the dissolution and other issues that may affect the viability of a §1031 exchange should be analyzed in advance of taking any such action. (See "What Happens When One Partner Does Not Want To Exchange?," October, 2006, *The New York Real Estate Journal*). Regardless, investors can diminish the risk involved in such a conversion by being proactive and converting ownership to tenants in common far in advance of any attempt to sell or market the property.

As with any tax situation, there are likely different options available to enable an investor to achieve his or her goals in any particular circumstance. Thus, appropriate legal and tax advice should be sought prior to taking any action.

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