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Partnership Distributions—A “Taxing” Problem for Exchangers

The IRS and the tax courts have long scrutinized transactions wherein partnerships dispose of property by first distributing the property to the partners who then sell or exchange their respective interest and –vice versa – transactions wherein the partnership exchanges and immediately thereafter distributes a tenant in common (“TIC”) interest to the partners.

The Drop and Swap: In a “drop and swap” transaction, the partnership conveys a fractional interest to each of the partners who then sell or exchange. The risk factors are as follows:

• The individuals who received their interest from the partnership may not meet the “qualified use,” i.e. the “held for investment” requirement of IRC section 1031 because the individuals received the property just prior to the exchange and for the sole purpose of selling it. See Rev Rul 75-292, 1975-2 Cum Bull 333; Rev Rul 77-337, 1977-2 Cum Bull 305 and Rev Rul 84-121, 1984-2 Cum Bull 168.

• The partnership’s transfer to the partners may be treated as a sale followed by a liquidation. Thus, the gain would be allocated to all of the partners.

• The IRS could argue that the new TIC ownership is really a partnership and therefore the transfer of the TIC interests in exchange for real property is really an exchange of a partnership interest which is excluded under section 1031(a)(2)(D).

Practitioners should review the following adverse rulings: *Chase v. Commissioner* (1989) 92 TC 874;*Crenshaw v. Commissioner* (5th Cir 1971) 450 F2d 472; Rev. Rul. 77-337, and *Commissioner v. Court Holding Co.* (1945) 324 US 331, 89 L Ed 981, 65 S Ct 707.

Likewise, practitioners should be wary of the two significant cases supporting the “drop and swap” – *Bolker v. Comm.* (1983) 81 TC 782, aff’d (9th Cir. 1985) 760 F2d 1039 and *Magneson v. Comm.* (1983) 81 TC 767, aff’d (9th Cir. 1985) 753 F2d 1490, because the facts in both cases arose prior to 1984 when section 1031 was amended to expressly exclude partnership interests. See section 1031 (a)(2)(D).

Although the “drop and swap” structure is inherently risky, certain actions may minimize the risk:

• The deed to the partners should precede the exchange for as long a period as possible;

• The sales contract for the property should be negotiated and executed by the tenant in common owners;

• The proceeds from the property should be distributed to the tenant in common owners; and

• The tenant in common owners should participate as the owners of the property for all income and expenses.

The Swap and Drop: In the alternative “swap and drop” transaction, the partnership exchanges into replacement property and immediately thereafter conveys a TIC interest to each partner. The IRS could argue that the replacement property was never held by the partnership for investment because it held the property only briefly before distributing it to the partners. See Rev Rul 75-292 wherein the IRS ruled against the taxpayer in a similar situation.

Minimize the risk – Obtain advice from a tax advisor experienced in partnership distributions and 1031 exchanges

Due to the complex nature of these transactions and the historical scrutiny by the IRS, taxpayers contemplating a pre or post exchange distribution should consult with their tax advisor well in advance of the contemplated transaction to ensure that they minimize any risk.

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