The Basics of 1031 Exchanges – Part Two: Structuring Partnership/LLC 1031 Exchange Cash-out Transactions

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January 26, 2017

This is part two of a two-part series on Internal Revenue Code Section 1031 tax-deferred exchange transactions. The first article provided an overview of the basic rules that govern 1031 exchanges. This article describes how things can get complicated if the partners in a partnership or the members of an LLC want to sell an investment asset but one or more partners want to “cash out” of the investment while other partners want to engage in a 1031 exchange.

Before we get started, it will be helpful to understand two tax rules that will be referred to extensively throughout this article.

- First, even though state law provides that a new partnership is created when the partners in the partnership change, tax law generally provides that a partnership continues to be the same taxpayer even when there is a change in the partners. However, a partnership will cease to be a partnership for tax purposes if only one partner of the partnership remains as an owner of the partnership property. If this happens, the remaining partner is deemed, for tax purposes, to be the owner of the asset(s) previously owned by the partnership.
- Second, an LLC, by default, is considered to be a partnership for tax purposes, unless the LLC makes a "check the box" election to be taxed as a corporation. Assume that any LLC described in this article has not made the "check the box" election.

What is a Partnership/LLC “Cash-Out” 1031 Exchange?

A partnership/LLC “cash-out” 1031 exchange occurs when the asset to be sold is held by a partnership or LLC but one or more partners or members (for ease of reference, both will be referred to as "partners") want to “cash-out” of the investment in the asset and receive cash from the sale of the property instead of re-investing all of the proceeds from the sale of the relinquished property into another investment or production asset that would serve as the replacement property. While other issues are discussed below, the main obstacles to address in a partnership/LLC “cash-out” 1031 exchange transaction are the “same taxpayer” rule and the “qualified use” requirement, which were described in Part One of this article.

- **Application of the “Same Taxpayer” Rule**: Since the asset involved in this type of transaction is held by a partnership or LLC, the IRS takes the position that the same partnership or LLC must both sell the relinquished property and purchase the replacement property. The same taxpayer rule is not a problem in situations where there are two or more partners remaining in the partnership or LLC. However, in a two-partner entity, this means that distributing out to one partner an interest in the relinquished property prior to the 1031 exchange in liquidation of the partner's interest in the partnership can be problematic since the reduction from two partners to one partner would automatically, by operation of law, result in the loss of partnership tax status. In such a case, the partner who was not redeemed out of the partnership would be deemed for tax purposes to be a new taxpayer holding the portion of the relinquished property that previously was held by the partnership. As more fully discussed below, the same taxpayer rule generally is not a problem in and of itself, but it can create significant issues regarding a taxpayer's ability to satisfy the "qualified use" requirement.

- **Application of the "Qualified Use" Requirement** : As explained in Part One of this article, both the partnership/LLC and the cash-out partner will have to establish that their ownership of the relinquished and the replacement property satisfies the "qualified use" requirement without reference to any other taxpayer's prior use of the property. This can become problematic if property is distributed out of the partnership/LLC shortly before the sale of the relinquished property or shortly after the acquisition of the replacement property.

It should be noted that the United States Tax Court decisions have been relatively taxpayer-friendly on these issues, but the IRS is still aggressive in auditing 1031 exchange transactions on this issue. Note also that it can be expensive to take a case through the IRS appeals process and through a trial at the Tax Court.

What Happens if a Partnership/LLC Cash-Out 1031 Exchange Transaction Fails?

While a taxpayer likely will not face any criminal penalties if a partnership/LLC cash-out 1031 exchange transaction is "blown up" by the IRS on audit, the financial consequences can be severe and likely would include:

- Significant tax liability related to the gain recognized on the sale of the relinquished property; and,
- A 20% penalty in addition to the tax.

Additionally, if a 1031 exchange fails, the taxpayer will have lost the use of the cash that was used to purchase the replacement property, although the taxpayer then would have a full cost basis in the replacement property.

What Options Does a Taxpayer Have to Structure a Partnership/LLC "Cash-Out" 1031 Exchange?

To help illustrate how the different partnership/LLC cash-out transactions could be structured, assume that (1) a raw, undeveloped piece of real estate (the "Property") is the only asset ABC, LLC owns and ABC, LLC has owned it for 10 years, (2) ABC, LLC is owned 50% by John Dirt and 50% by Jane Cash, and (3) Jane Cash wants to receive cash from the sale of the Property, but John Dirt wants to engage in a 1031 exchange via ABC, LLC and invest in new replacement property real estate.

- **Option 1 – Drop and Swap** : An example of a "drop and swap" transaction would be one in which (1) ABC, LLC would first distribute a 50% undivided interest in the relinquished property to Jane Cash in liquidation of her ownership interest in ABC, LLC (leaving the Property being owned 50% by ABC, LLC and 50% by Jane Cash as tenants-in-common), (2) ABC, LLC would sell its 50% interest in the Property and Jane Cash would sell her 50% interest in the Property, (3) Jane Cash would keep her cash and pay tax on her sale transaction, and (4) ABC, LLC would engage in a 1031 exchange and purchase new replacement property.

- Issue 1 – Same Taxpayer Rule: The same taxpayer rule could be an issue here since ABC, LLC (as a twomember LLC) would lose its status as a partnership when Jane Cash is redeemed out of ABC, LLC in exchange for her 50% interest in the Property. This obviously is not an issue if the entity has multiple partners who do not want to cash-out, as the partnership/LLC would continue to be a multi-partner partnership and therefore would not lose its tax status as a partnership.

- <u>Issue 2 – Qualified Use Requirement</u>: The qualified use rule could also be an issue here since, due to the same taxpayer rule, ABC, LLC becomes a new taxpayer after the redemption of Jane Cash's LLC interest in exchange for her 50% interest in the Property. Because ABC, LLC is a new taxpayer, it must establish that it (as a separate taxpayer and without any reference to ABC, LLC's prior 10 year ownership of the Property) has satisfied the qualified use requirement. While ABC, LLC's holding period for other tax purposes will include both its pre-redemption and post-redemption holding period, the holding period and use by ABC, LLC will not be imputed to the new single-partner partnership/LLC for purposes of determining whether the new single-partner partnership/LLC has satisfied the qualified use requirement.

- <u>Issue 3 – Deemed Partnership</u>: The IRS also attacks drop and swap transactions by arguing that the exiting partner (Jane Cash in our scenario) and the partnership/LLC become involved in a "deemed/de facto partnership" subsequent to Cash's exit from ABC, LLC and that the purported 1031 exchange of real estate in substance really involves an exchange of a partnership interest, which is not a type of property that can be exchanged in a 1031 exchange. The key to addressing this issue is limiting the amount of management powers that can be exercised by the owners of the subject property, which will be easier for a raw, undeveloped tract of land than for a real estate asset like an operating shopping center.

As a result, partners contemplating a drop and swap transaction should consider entering into a Tenant in Common Agreement ("TIC Agreement") as part of the distribution by the partnership/LLC of the undivided interest to the cash-out partner. The TIC Agreement will specifically define and limit the partners' management powers in order to provide additional evidence to support the tax-deferred nature of the transaction if the IRS conducts an audit of the transaction.

Additionally, it should be noted that the IRS is targeting drop and swap transactions, and that this type of transaction must now be disclosed via a relatively new question on the partnership tax return form.

- **Option 2 – Swap and Drop**: An example of a "swap and drop" transaction would be one in which (1) ABC, LLC sells the Property and engages in a 1031 exchange by buying new replacement real property (the "New Property"), (2) ABC, LLC then distributes a 50% interest in the New Property to Jane Cash in liquidation of her ownership interest in ABC, LLC (resulting in the New Property being owned 50% by ABC, LLC and 50% by Jane Cash as tenants-in-common), and (3) Jane Cash then sells her 50% interest in the New Property and pays tax on her sale transaction.

- <u>Issue – Qualified Use Requirement</u>: The qualified use rule could be an issue here since the LLC must hold the New Property for a sufficient period of time after the 1031 exchange before it distributes the 50% interest in the New Property to Jane Cash in order to satisfy the qualified use requirement.

- <u>Practical Issue – Time Involved</u>: Due to the time involved to market and sell the relinquished property on the front end, hold the New Property inside the partnership/LLC after the 1031 exchange, and then market and sell the cash-out partner's interest in the New Property on the back end, the swap and drop transaction generally takes a very long time to generate cash proceeds for the cash-out partner.

As is true with drop and swap transactions, the IRS is also targeting swap and drop transactions and this type of transaction must now be disclosed via a relatively new question on the partnership tax return form.

- **Option 3 – Partnership Installment Note Transaction**: An example of a partnership installment note transaction (sometimes referred to as a "PIN" transaction) is one in which (1) ABC, LLC sells the Property and engages in a 1031 exchange where the consideration it receives consists in part of cash with the remainder consisting of an installment payment Promissory Note pursuant to which payments are made over a period of two or more tax years, (2) ABC, LLC uses the cash to complete a 1031 exchange by acquiring replacement property, and (3) ABC, LLC distributes the installment Promissory Note to Jane Cash in redemption of her interest in ABC, LLC, with the installment Promissory Note portion of the transaction resulting in taxable gain.

- Issue 1 – Same Taxpayer Rule: The same taxpayer rule could be an issue here since ABC, LLC would lose its tax status as a partnership when Jane Cash is redeemed out of ABC, LLC in exchange for the installment Promissory Note. Once again, this obviously is not an issue if there are multiple partners who remain in the partnership/LLC after the cash-out partner is redeemed out of the partnership.

- Issue 2 – Qualified Use Requirement: If the partnership/LLC loses its tax status as a partnership very soon after the 1031 exchange is completed, then the IRS may contend that the partnership did not satisfy the qualified use requirement since it held the replacement property for such a short period of time after the 1031 exchange.

- Issue 3 – Allocation of Gain: With this type of transaction, there is a question about whether a special allocation of the taxable gain resulting from the installment Promissory Note can be made solely to the cash-out partner who ultimately receives the installment Promissory Note, or whether this gain must be allocated to all of the partners on a pro rata basis. This issue arises because the receipt of the installment Promissory Note as consideration in the 1031 exchange is treated as "boot" and therefore results in partial tax recognition. This means that the partners who remain in the partnership/LLC could be allocated the taxable gain related to the cash payments made on the installment Promissory Note to the cash-out partner.

- **Other Alternative Transaction Structures**: There are variations of the above-described drop and swap, swap and drop, and PIN transaction structures that can be used to address deal-specific issues and also provide additional protection against an IRS audit. There also are several additional transaction structures that can work under the right circumstances, including a partnership division transaction, and a cash buy-out by the remaining partners of the cash-out partner before a 1031 exchange.

Conclusion: Partnership/LLC Cash-out 1031 Exchange Transactions Are Complex

As can be seen from the above discussion, there is nothing simple or straightforward about structuring a partnership/LLC cash-out transaction. Consequently, it is important for anyone contemplating one to obtain the advice of an experienced tax professional familiar with structuring 1031 exchanges. Additionally, the earlier the planning process is started the better since some of these transaction structures require significant lead time before the deal has "ripened" so that the transaction will result in the least amount of IRS audit risk.

Members of Ward and Smith's Tax Practice Group and Real Estate Practice Group have structured many partnership/LLC cash-out 1031 exchange transactions and can work with you and your other advisors to properly implement your partnership/LLC cash-out transaction.

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