EXCHANGING WHEN A PARTNER WANTS OUT

Often a partnership owns real estate, but not all of the partners want to remain in the partnership. One or more of the partners "wants out" of the partnership. This document lists some of the techniques that have been employed when the partnership wants to do an exchange of real estate, but allow some of the partners to exit the partnership. The list of issues is not exhaustive, for example, you must also analyze the effect of changes in partner's liabilities:

DROP & SWAP

Procedure: In the "drop and swap," the partnership distributes undivided interests in the relinquished property to the partners. The partners as separate taxpayers either exchange or sell their undivided interests in the relinquished property.

Issues:

- Have the partners held the property for business or investment?
- Will the IRS apply the "step-transaction doctrine"?
- Is the co-ownership after the "drop" a partnership for tax purposes?
- Economic true up after distribution becomes difficult since a partnership no longer exists.

SWAP & DROP

Procedure: In this situation, the partnership as an entity does the exchange and after the exchange is completed, the property is distributed to the partners. Often the exchange involves acquiring multiple smaller properties that are distributed among the partners, with cash being used to equalize distributions.

Issues:

- Does intent to distribute defeat the partnership's intent to hold the property for business or investment?
- Will the IRS apply the "step-transaction doctrine"?
- Ability to identify multiple replacement properties is limited by three property and 200% rule.

SWAP BUT DON'T DROP

Procedure: The partnership exchanges a large property into multiple smaller properties, but uses "tracking allocations" so that the partner gets most of the benefits from a particular property. The partnership remains together (similar to a legal separation), but each partner principally is allocated the tax items from "his" particular property. Unfortunately, a 100% allocation will not work and, typically, an allocation of 80% to 90% of the items of a particular property is used for some period of time.

Issues:

- Difficulty in acquiring multiple properties-limited number of properties under ID rules.
- Difficulty in matching values of replacement properties to partner's interests in partnership.
- Tracking allocations cause accounting problems.
- Have the partners really accomplished anything of substance if still under the same partnership?

CASH OUT PARTNER BEFORE THE EXCHANGE

Procedure: The partnership redeems the interest of the partner wanting to cash out before the exchange takes place. The partnership can then do an exchange. This may work with a partnership with cash redeeming out a partner with a small partnership interest, but is difficult for significant interests.

Issues:

- Source of funds to redeem partner.
- Refinancing of property before exchange.
- Partnership needs to exchange into bigger property with fewer partners.
- Use of note to redeem partner does not produce good tax result for partnership.
- Possible technical termination if over 50% interest is redeemed.

CASH OUT PARTNER AFTER THE EXCHANGE

Procedure: The partnership exchanges into credit tenant lease property that can be refinanced after the exchange. The partnership can then use the funds to redeem a partner wanting out of the partnership.

Issues:

- Technical termination if redeeming over 50% interest.
- Step transaction doctrine for "paydown-readvance" feature of CTL property.
- Phantom income on highly leveraged CTL-partnership's problem after redeeming the partner.

USING INSTALLMENT NOTE TO REDEEM PARTNER

Procedure: The partnership sells the relinquished property to the third party buyer for cash plus an installment note from the buyer. The buyer secures its obligations under the note with a standby letter of credit. Afterward, the partnership distributes the installment note to the partner wanting out. The installment note is "boot" but the timing of reporting the gain attributable to the note will be according to the installment method.

Issues:

- Application of step transaction doctrine.
- Need to secure buyer's cooperation in setting up letter of credit.