# ACQUIRING PARTNERSHIP INTEREST AS REPLACEMENT PROPERTY

Finding suitable replacement property is one of the biggest challenges in completing a like-kind exchange. The difficulty in finding replacement property has created an industry around finding replacement property. Single tenant net leased property and tenant-in-common property are now commonly used replacement property strategies. An overlooked source of replacement property is partnership interest replacement property ("PIRP").

Internal Revenue Code Section 1031(a)(2)(D) expressly makes partnership interests ineligible for exchange on a tax deferred basis. There are two situations in which partnership interests may be acquired as replacement property in an exchange:

1. Acquiring 100% of the partnership interest in an existing entity;
2. Acquiring the remaining partnership interest in an entity in which the taxpayer is already a partner.

## Technique 1: Acquiring 100% of Partnership Interest as Replacement Property

Despite the Code's prohibition on exchange treatment for partnership interests, the exclusion does not apply when the partnership is a disregarded entity at the time the exchange is completed. A disregarded entity is one owned by a single taxpayer. A single member LLC or limited partnership in which all partnership interests are owned by a single taxpayer can be disregarded entities. It is much more difficult (though not impossible) for a corporation to be a disregarded entity.[1] One reason for acquiring all of the interests in an existing entity that owns the replacement property is to avoid transfer taxes. Many jurisdictions do not assess a transfer tax on the sale of an existing entity that owns real estate.[2] In such states, significant savings can be achieved. In Private Letter Rulings,[3] the Service held that a taxpayer's acquisition of the sole membership interest in a LLC that owned the replacement property is treated as if taxpayer received title to the relinquished property directly.

An existing partnership entity can also be parked by an exchange accommodation titleholder in a reverse exchange. The accommodator must own all of the partnership interest to be considered the tax owner of the property. While the accommodator will have some additional issues to address in its indemnity agreement, parking of partnership interest should also be able to achieve the same results as are available in a forward exchange, constituting valid replacement property and avoiding multiple transfer taxes, as well as obtaining the benefit of solving the timing problems through use of a reverse exchange.

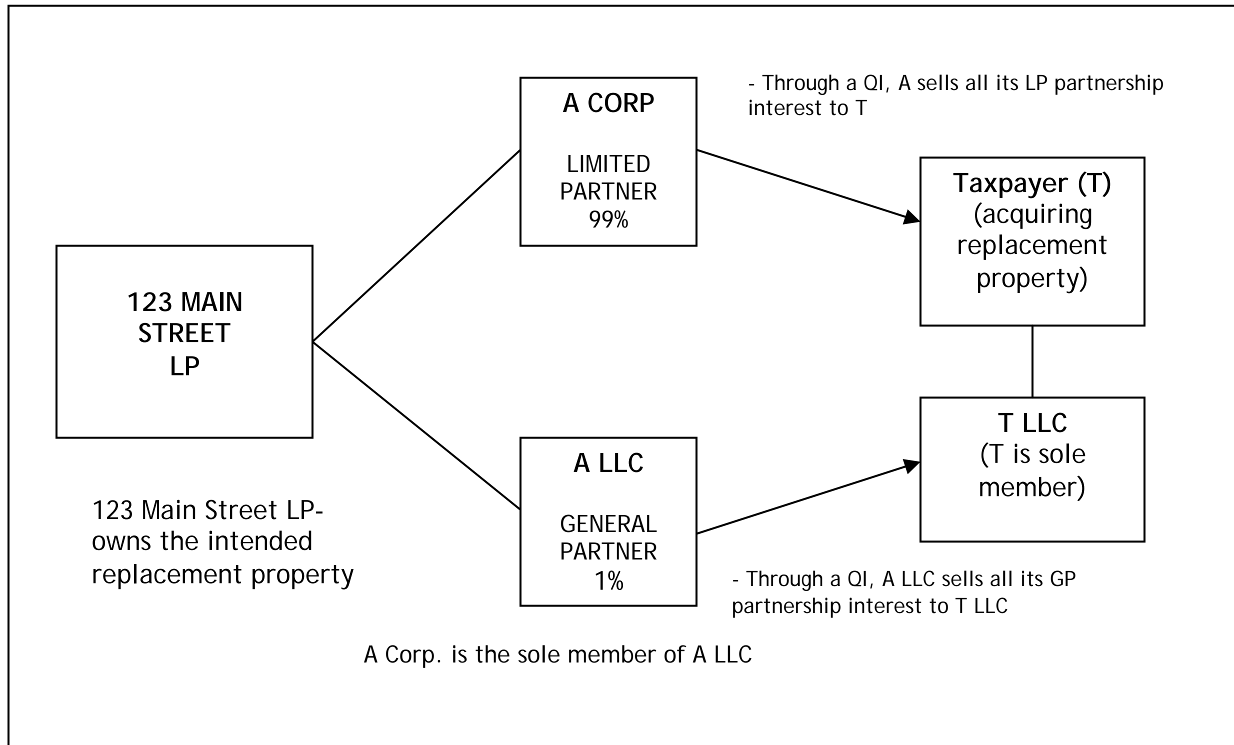


**ILLUSTRATION OF TECHNIQUE 1:**
**ACQUIRING 100% OF PARTNERSHIP INTEREST AS REPLACEMENT PROPERTY**

### Technique 2: Acquiring Remaining Partnership Interest as Replacement Property

Another replacement property strategy is when the taxpayer is already a partner in a partnership. In this situation, the taxpayer can acquire all the remaining interest of the other partners. The taxpayer must own all of the partnership interest at the time that the exchange is completed. Rev. Rul. 99-6[4] dealt with a situation involving a two member LLC taxed as a partnership. One partner sold all of its partnership interest to the other partner such that the partnership technically terminated under IRC §708, and the LLC became a disregarded entity. The Service stated that the partnership is treated as having distributed its assets in liquidation to the partners, and the <u>purchasing partner is deemed to have purchased the assets</u> deemed to have been distributed to the other partner.

While this ruling does not specifically mention like-kind exchanges, it purports to broadly describe the federal tax treatment in going from a partnership to a disregarded entity. Based on this ruling, a taxpayer can take a transaction that is in form a purchase of a partnership interest, and treat it in substance as if it is a purchase of the underlying assets. If the LLC owns other assets, these assets will become part of the purchase. If this transaction is part of the exchange, the effect of receiving different classes of property must be considered (including Treas. Reg. §1.1031(j)-1). A taxpayer having an interest in a joint venture can buy the interest of its joint venture partner, and have the assets attributable to that partner's interest be considered replacement property in an exchange.

Using this technique frequently raises the issue of the "identity of taxpayer." In every exchange, the same taxpayer for federal income tax purposes must sell the relinquished property and acquire the replacement property.[5] Therefore, the taxpayer must be a partner in the partnership that owns the replacement property. This situation can sometimes be cured, given ample time to plan for changes in ownership of the partnership interest prior to the sale of the relinquished property.

Parking of a partnership interest consisting of less than all of the partnership in a Rev. Proc. 2000-37 parking arrangement poses additional complexities. The exchange accommodation titleholder must acquire "qualified indicia of ownership" in the replacement property.[6] If the accommodator owns less than all of the partnership interest, it would not fall within the specified methods of acquiring "qualified indicia of ownership" under the Revenue Procedure. One rationale justifying acquiring less than all of the partnership interest as replacement property is that if the same partnership interest can be acquired as replacement property in a forward exchange, the same treatment should conceivably follow from a parking transaction, since safe-harbor parking is intended as a means of solving the problem of the reversal of timing in an ordinary deferred exchange. With the exchange accommodation titleholder becoming an actual partner in the partnership, the taxpayer and the EAT must also address the financial and tax consequences of EAT's ownership of a partnership interest. This requires deciding how to handle the income and cash flow generated by the partnership. It is also important that the taxpayer and EAT focus on items affecting the EAT's outside basis (basis of the EAT's partnership interest). These issues require sophisticated partnership tax advice.

## Conclusion

Acquiring partnership interest is another replacement property strategy that taxpayers should consider in attempting to structure and complete an exchange. This overlooked source of replacement property may help many taxpayers (particularly institutional real estate investors) complete exchanges that they thought would be considered taxable transactions for failure to acquire replacement property.

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Footnotes:

[1] See: Commissioner v. Bollinger, 485 U.S. 240 (1988).

[2] Many states "look through" the entity and tax a change in beneficial ownership of any entity owning real estate, e.g. New York and Washington, DC. Some have a threshold of change (e.g. Connecticut taxes changes in ownership of more than 50%).

[3] See: PLR 200118023 (1/31/01).

[4] Rev. Rul 99-6, 1999-1 C.B. 6.

[5] Sometimes, a change in taxpayer is acceptable, for example in connection with a mid-exchange merger in which the tax attributes carry-over under 26 U.S.C. §381. See, e.g. PLR 9252001 (2/12/92).

[6] See: Rev. Proc. 2000-37, 2000-2 C.B. 308, Section 4.02 (1): "Qualified indicia of ownership" means legal title to the property, other indicia of ownership of the property that are treated as beneficial ownership of the property under applicable principles of commercial law (e.g. contract for deed), or interests in an entity that is disregarded as an entity separate from its owner for federal income tax purposes (e.g. a single member limited liability company) and that holds either legal title to the property of such other qualified indicia of ownership.