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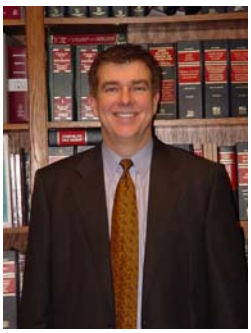
Reprinted from:

THE SOUTHEAST'S REAL ESTATE SOURCE

SOUTHEAST REAL ESTATE BUSINESS™

Volume 4, Issue 5 August 2003



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Like-Kind Exchanges and Partnerships

Like-kind exchanges offer a tremendous opportunity for real estate owners to defer tax. Partnerships (which include limited liability companies) are the preferred entity in which to own real estate. For this article, we want to focus on a common scenario involving like-kind exchanges and partnerships. The scenario involves a sale of appreciated real estate by a partnership in which some partners want to cash out and some partners want to defer their gain by receiving replacement real estate.

The Problem

If the partnership sells the appreciated real estate and receives like-kind replacement real estate and cash (intended for the partners who want to cash out) the partnership will recognize gain to the extent of the cash received. The problem is the tax will typically be allocated to all of the partners, including the partners who want to remain in the partnership and participate in the like-kind exchange.

Drop and Swap

A common solution is to have the partnership distribute undivided interests in the real estate to the partners (the drop) and allow the partners to either cash out or receive replacement real estate on an individual basis (the swap). This structure raises several unresolved tax issues. First, if the distribution to the partners occurs immediately before the sale or if the partnership has already contracted to sell the real estate, there is a risk that the partners have not held the property for investment or for productive use in a trade or business, which is a requirement to qualify for a like-kind exchange. Second, after the distribution to the partners there is an issue whether the relationship between the owners of the real estate will be considered a partnership for tax purposes. If the arrangement is treated as a partnership for tax purposes, the like-kind exchange will fail because the partners will be treated as exchanging partnership interests (which do not qualify for like-kind exchange treatment) for real estate. The IRS has recently issued guidance as to the factors they will consider in determining whether the ownership of property among co-owners will be considered a partnership for tax purposes. Finally, in the real world, it is often difficult and time consuming to obtain the approval of a lender to transfer real estate securing a loan from a partnership to the partners.

Installment Note Method

Under this structure, the buyer transfers cash (to be held by a qualified intermediary to purchase replacement real estate) and an installment note to the partnership. The installment note will be used to cash out the partners who want to exit. It should be possible to structure the installment note so that 95% or more of the payments are made shortly after closing with the remaining payment to be made at the beginning of the next taxable year. This structure should work because no gain is recognized by the partnership upon receipt of the installment note and the installment note can be distributed to the partners looking to cash out without triggering gain. The partners who receive the installment note will pay their tax when they receive payments on the installment note. The partnership will receive the replacement real estate. This structure allows the existing partnership to remain in place.

Conclusion

Planning a transaction in this area requires knowledge of the like-kind exchange rules as well as a recognition of the opportunities available to partners exiting a partnership. Because of the requirements of a like-kind exchange, taxpayers owning appreciated real estate in partnerships should also consider other planning options to defer the tax on the sale of the appreciated property.

The authors of this article, Bill Culp and Mark Richardson, are tax attorneys with the tax law firm of Culp Elliott & Carpenter, P.L.L.C., located in Charlotte, North Carolina. They spend a substantial amount of their time advising real estate owners and developers on structuring deals to achieve the desired business and tax results. They can be reached at the following e-mail address: mlr@ceclaw.com.