ROBERTS & HOLLAND LLP

June 22, 2005

When Partners Divorce: Structuring Tax-Free Divisions of Real Estate

By: Ronald A. Morris and Ezra Dyckman

Financial success is no barrier to discord. In fact, it sometimes seems to foster it. Business partners seem to seek respite in divorce almost as often as marital partners. Even when the partners are getting along, they may foresee problems upon succession of the next generation; in other cases, the partners may be at each others' throats. Where a sale to a third party is not desirable, the partners desperately seek a tax-effective method of dividing their assets and going their separate ways. This simple goal is often difficult to realize.

Take the simple case of a two-partner partnership that owns many assets. Since partnership distributions are generally tax-free, the partnership can simply distribute half of its properties to each partner in liquidation of his or her interest. Note that even in this "easy" case, care must be taken to avoid gain under various partnership tax provisions (particularly when it comes to equalizing the values of the distributions to each partner).

In the real estate context, however, partners typically form a separate partnership for each asset. When partners propose to split up assets held in multiple partnerships, new obstacles arise. Take the case of Partnership 1 and Partnership 2 which are each owned equally by A and B. Partnership 1 owns Property 1 and Partnership 2 owns Property 2. If A receives the asset held by Partnership 1 and B receives the asset held by Partnership 2, the partners will be deemed to have exchanged partnership interests or to have exchanged partnership interests for real estate, transactions that do not qualify for tax-free treatment under any provision of the Internal Revenue Code, including section 1031 (dealing with exchanges of like-kind property). The following are two approaches that are frequently proposed to solve this problem:

Like-Kind Exchange Approach

Since an exchange of partnership interests is taxable, one approach is to execute a like-kind exchange on the partnership level as follows:

Step 1: Partnership 1 transfers a 50 percent tenancy-in-common interest in Property 1 to Partnership 2, in exchange for a 50 percent tenancy-in-common interest in Property 2, in a transaction qualifying under Code section 1031.

(After this step each partnership owns a 50 percent tenancy-in-common interest in each property.)

Step 2: Partnership 1 and Partnership 2 each distribute their tenancy-in-common interests in Property 1 to A and their tenancy-in-common interests in Property 2 to B.

Deemed Partnership Issue. Section 1031(a)(2) states that the nonrecognition principles of section 1031 will not apply to an exchange of partnership interests. In the transaction format described above, depending on the terms of the tenancy-in-common and the nature of the properties, there is a chance that the tenancy-in-common interests could be deemed to be partnership interests, thus disqualifying the exchange. The determination of whether a tenancy-in-common is a partnership for income tax purposes depends on many factors including the degree to which decision making is centralized and the level of activity. This topic, however, is beyond the scope of this article.

Holding Purpose Requirement. Code section 1031(a) requires that both the property exchanged by the taxpayer and the property received by the taxpayer be held either for productive use in a trade or business or for investment. The Internal Revenue Service has often taken the position that a transaction does not qualify under section 1031 if the property acquired is immediately disposed of in a subsequent nontaxable transaction, particularly when the subsequent disposition is prearranged, as the replacement property will not have been held for a qualified purpose.

In *Maloney v. Commissioner*, 93 T.C. 89 (1989), the Tax Court held that investment property held by a corporation, which was exchanged for other investment property qualified for nonrecognition treatment under Code section 1031, even though the property was then distributed to the shareholders in complete liquidation of the corporation. (The distribution was nontaxable under former Code section 333.) The Service argued that the exchange did not qualify for nonrecognition treatment because the corporation did not hold the property it received for productive use in its trade or business or for investment since it intended to distribute the property to its shareholders in a liquidating distribution. The court found in favor of the taxpayers, noting that the shareholders continued to have an economic interest in essentially the same investment and merely changed their form of ownership by removing the interposition of the corporation. The court concluded that the addition of another nontaxable transaction, such as a liquidating distribution, did not automatically destroy the nontaxable status of the exchange under section 1031.

In *Magneson v. Commissioner*, 81 T.C. 767 (1983), *aff'd* 753 F.2d 1490 (9th Cir. 1985), the Tax Court determined that the taxpayers' exchange of property qualified for tax-free treatment under section 1031, even when, pursuant to a prearranged plan, the property received in the exchange was contributed to a partnership in exchange for a general partnership interest. The court found that the taxpayers met the statutory requirement that the property received in the exchange be "held" for investment or for productive use in a trade or business, as the taxpayers' relationship to the acquired property was not changed by the subsequent contribution of the property to the partnership. The Ninth Circuit affirmed the Tax Court and found that the holding requirement had been met.

Although the Service has lost a number of cases regarding proper holding purpose, its current position remains contrary to those decisions. Moreover, it is possible that these decisions are distinguishable from the facts in a given case (for example, a transaction involving a limited partnership may differ from the contribution to a general partnership in *Magneson*). In light of this, if the distribution in Step 2 occurs shortly after the like-kind exchange in Step 1, the exchange could be disqualified.

Step Transaction Issue. If Step 1 and Step 2 occur close together, and if it is predetermined which partner will receive which property in Step 2, the Service could argue that the steps should be collapsed (effectively ignoring the tenancy-in-common structure) and that what really occurred was a taxable exchange of partnership interests, since the intervening steps had no independent significance. The more time that elapses between Steps 1 and 2, the less risk there is that the Service could successfully ignore the tenancy-in-common structure. In addition, even if Steps 1 and 2 are chronologically separated, the transaction will still be vulnerable to a step transaction attack if a binding contract determines from the outset who will get Property 1 and who will get Property 2 when Step 2 occurs.

Section 1031(f). Section 1031(f) invalidates a like-kind exchange between related parties (which this would be since 100 percent of Partnership 1 is owned by the owners of Partnership 2) if the exchanged property is disposed of within two years. A distribution may be a disposition for this purpose. Therefore, one would have to wait two years between Steps 1 and 2 to preserve section 1031 qualification. If this two-year waiting period is observed, then the holding purpose issue and step transaction issue discussed above are probably not significant risks (assuming that it is not determined who will get each property until the two years have passed).

Transfer Taxes. For New York State and New York City transfer tax purposes, both steps are "transfers." In the simplified scenario discussed here, there would be a 100 percent mere-change-in-form exemption with respect to the exchange of tenancy-in-common interests (and thus no transfer tax would be due) and a 50 percent mere-change-in-form exemption upon the subsequent distributions to the members. If the interests in each entity are instead owned by various members of two families, the actual transfer tax cost could be greater.

Merger Approach

Another possible approach is to merge the partnerships as follows:

Step 1: Partnership 1 and Partnership 2 merge.

Step 2: The merged entity, which then owns both properties, distributes Property 1 to A and Property 2 to B.

Disguised Sale Issue. Regulations under section 707 of the Code provide that, in general, if a partner contributes property to a partnership and receives a distribution from the partnership within two years, the transfers are presumed to be a sale of the property by the partner to the partnership. Treasury Regulations governing partnership mergers provide that a partnership that terminates as a result of a merger is generally treated (i) as having contributed its assets to the surviving partnership in exchange for a partnership interest and then (ii) as having liquidated, distributing interests in the surviving partnership to its partners. In our case (assuming that Partnership 1 survives and Partnership 2 terminates) Partnership 2 is deemed (i) to transfer its assets to Partnership 1 in exchange for interests in Partnership 1 and then (ii) to distribute interests in Partnership 1 to A and B. Then, in Step 2, Partnership 1 distributed Property 1 to A. As a result, there is a deemed contribution of property (Property 2) by Partnership 2 and there is a related transfer of property (Property 1) to Partnership 2's successor-in-interest, *i.e.*, A. Therefore, the merger combined with the distribution is presumed to be a disguised sale if the two steps occur within a two-year period.

Seven-Year Rule Issues. Code section 704(c)(1)(B) provides that if property contributed by one partner is distributed to another partner within seven years of its contribution, the contributing partner will recognize the "built-in gain" that was inherent in such property at the time of contribution. In this case (again under the partnership merger regulations and assuming Partnership 1 is the surviving entity for tax purposes), Partnership 2 will be a "contributor" under section 704(c) since it will be deemed to have contributed assets to Partnership 1 with differing book and tax values. Treasury Regulations under Code section 704(c) provide that a transferee of a contributing partner is treated as a contributing partner for purposes of section 704(c)(1)(B). As a result, A, who will be deemed to receive from Partnership 2 a liquidating distribution of an interest in Partnership 1, will be a transferee of Partnership 2 and, therefore, will be treated as a contributing partner with respect to his share of Property 2 (50 percent). As a result, section 704(c)(1)(B) will cause gain recognition upon a distribution of Property 2 to B within seven years of the merger. A related seven-year rule under Code section 737 would also be implicated.

Step Transaction Issues. The merger step might be ignored under the step transaction doctrine: (a) if it is predetermined which property each distributee will receive; or (b) if income from the merged entity is not shared in the interim.

Transfer Taxes. The transfer tax effect is similar to that with respect to the like-kind exchange transaction. Both the merger and the distribution are "transfers." The merger transfer will be taxable only to the extent that there is differing ownership of the properties. The distribution of the properties will be taxable to the extent of 50 percent of each property.

Conclusion

As you can see, both approaches come with significant tax baggage; however, from a logistical, practical perspective, the merger format is usually preferable. When dealing with a large number of entities and partners, the difficulty of creating, exchanging and maintaining numerous tenancies-in-common can be enormous.

Even using a merger format, a certain level of complexity is unavoidable given the minefield of issues that must be navigated. Nevertheless, certain techniques have been developed to deal with many, if not all, of these problems. Since the facts of each specific case differ, other options may arise based on the particular circumstances of the particular case. As a result, while the approaches described above are helpful points of departure, there is no substitute for analyzing each case anew.