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CREATIVE TAX PLANNING IDEAS FOR BUYING AND SELLING REAL ESTATE

by

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CREATIVE TAX PLANNING IDEAS FOR BUYING AND SELLING REAL ESTATE*

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Clients selling real estate desire in many cases to pay no tax by doing a Section 1031 tax-free exchange. Clients that do pay taxes on the sale of their real estate generally desire to be taxed at lower long-term capital gain rates.

The federal long-term capital gain rate[1] is currently at a low maximum 15% rate, with straight-line depreciation and amortization recapture on real estate taxed at a 25% rate. Additionally, California imposes a 9.3% maximum tax rate, and for tax years beginning after January 1, 2005 there is an additional 1% California income tax surcharge for taxable income in excess of

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* This article discusses general planning techniques and should not be used as to a particular transaction without the specific advice of the taxpayer's own retained tax professional. These techniques require careful analysis. Accordingly, taxpayers should obtain the advice of their own accountants and tax attorneys as to their specific factual situation.

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[1] Long-term capital gain rates apply to a sale of property which is a capital asset held more than one year. Also, Section 1231 gains are treated as long-term capital gains.

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$1,000,000.[2] Finally, the alternative minimum tax may apply to the client.

1. **<u>HOW CAN A CLIENT WHO REGULARLY BOUGHT AND SOLD REAL ESTATE IN THE PAST NOW RECEIVE LONG-TERM CAPITAL GAIN TREATMENT ON THE SALE OF A NEW PARCEL OF REAL ESTATE</u>**?

Clients who sell real estate desire to receive capital gain treatment on their sale's gain. However, if the real estate is not classified as a sale of a capital asset or is a "sale of property primarily held for sale to customers in the ordinary course" of the client's trade or business, then the client will receive ordinary income treatment on the sale of that real estate. The client's goal is to evidence that they held that real estate for "investment purposes" and <u>not</u> for sale in the ordinary course of a trade or business. One analysis to determine whether the client held the real estate for investment purposes (and <u>not</u> for sale in the ordinary course of a trade or business) is by determining the following:

(i) Was the client engaged in a trade or business, and if so, what was that business;

(ii) Was the client holding the real estate primarily for sale in that business; and

(iii) Were the sales contemplated by the client "ordinary" in the course of that client's business.[3]

1.1 ***<u>Factors Which Determine if a Client is in the Trade or Business of Selling Real Estate</u>***. There is no bright line test to determine whether or not a client is engaged in the trade or business of selling real estate (and thus receiving ordinary income treatment on the sale of their real estate instead of capital gain treatment). However, the factors to make this determination are discussed below:

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[2] See Section 17043(a) California Rev. and Tax. Code.

[3] See this test discussed in ***Suburban Realty Co.***, 615 F2d 171 (5th Cir. 1980), *cert. den*. 449 US 920 (1980).

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(a) ***The Number of the Client's Sales of Parcels of Real Property***. Large numbers of lot sales by the client over a short period of time indicate that the client is in the trade or business of selling real estate.

(b) ***Extent of the Client's Subdividing Activities***. Clients who engage in real estate development activities appear to be more in a trade or business than those clients who simply hold real estate for investment, rental and appreciation. Thus, clients who put subdivision improvements on the land appear to be in a trade or business.[4] On the other hand, where the taxpayer only did non-physical improvements to the land such as obtaining governmental approvals for the land's subdivision into multiple lots was found by the Tax Court to not be engaged in a "trade or business," and accordingly the Court held that the land remained a capital asset.[5]

(c) ***Extent of the Client's Activities to Sell the Real Estate***. If the client actively markets the sale of the real estate and solicits proposed offers, opens a sales office to sell the real estate, and devotes substantial time to the real estate's sale, then all of these activities indicate a client's trade or business of selling real estate.[6]

(d) ***Client's Intention Regarding the Real Estate Immediately Prior to the Real Estate's Sale***. Did the client immediately before the sale of the real estate intend to hold that real estate for "investment," or was the client intending to hold that real estate for resale? To determine a client's intention, the courts look at a client's conduct over a period of time prior to the real estate's sale.[7] Thus, taxpayers who own real estate for long time periods can argue that their intention was to hold that real estate for investment purposes (and not for resale).

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[4] See ***Biedenharn Realty Co.***, 526 F2d 409 (5th Cir. 1975).

[5] See ***Buono***, 74 TC 187 (1980).

[6] See ***Biedenharn Realty Co.***, 526 F2d 409 (5th Cir. 1975).

[7] See ***Heller Trust***, 382 F2d 675 (9th Cir. 1967).

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Clients can <u>change their intention</u> over time from their primary intention when they originally acquired the real property. In other words, a client can have a subsequent change in purpose from when they originally purchased the property. A change of purpose might be indicated, for example, if improvements were made to the property after the property was purchased or if the property is subsequently subdivided for resale to customers.

1.2 ***Planning Techniques On How "Dealer" Clients Can Sell Their Real Estate at Long-term Capital Gain Rates***. Clients who might be classified as "dealers" of real estate and taxed on their property's sales at high ordinary income tax rates because they regularly bought and sold property in the past, can still structure their future real estate sales transactions at lower long-term capital gain rates.

"Dealer" clients should take the following actions to obtain long-term capital gain treatment on their future real estate sales:

(a) The client should purchase new property (which they intend to later sell) in a single-asset new taxpayer entity.[8]

(b) This single-asset taxpayer entity should own the newly purchased real property for as long a time as possible in order to evidence that entity's intention to hold that property for appreciation and not for resale.

(c) This new legal entity preferably should not be controlled by persons who might be classified as "dealers" in property, and instead should be controlled by persons who would be classified as "investors."

(d) The entity's federal and state income tax returns should indicate that the entity is an "investor" in real estate, and <u>not</u> a developer or dealer of property. The tax returns should <u>not</u> classify the real estate as inventory and the tax returns should instead report the new real estate as investment property.

(e) Limit any improvements constructed on the property to those improvements which are for the property's investment (such as improvements to hold the real estate as a rental building), and do not do improvements for the subdivision and sale of the property

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[8] See ***Cary***, 32 TC Memo 1973-197; and ***Bramblett***, 960 F2d 526 (5th Cir. 1992).

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(for example, do not do improvements of constructing roads and utilities for the land's subdivision since this evidences the client to be a seller or dealer of the property).

(f) The real property should not be marketed for sale in multiple lots, nor should the real property be marketed for sale with a broker immediately after its acquisition or improvement.

(g) Preferably, the real property should be sold in the form of one transaction to one person. The number of sales is an important factor to determine dealer status.

2. **PLANNING TECHNIQUE FOR CLIENTS TO BE TAXED AT LONG-TERM CAPITAL GAIN RATES WHEN THE CLIENT SELLS RESIDENTIAL LOTS OR CONDOMINIUM UNITS**.

Clients who subdivide land (or develop condominium units) and then sell the subdivided and developed land (or condominium units) normally have their entire gain taxed at high ordinary income tax rates, since the client is classified as a "dealer" selling "inventory" in the form of the subdivided lots (or condominium units). By proper tax planning, clients, instead of being taxed at ordinary rates on the entire gain, can be taxed at lower long-term capital gain rates on the land's appreciated value by engaging in the following tax plan:

First, the client after owning the land in a partnership for over one year sells that land[9] to a controlled subchapter S corporation in exchange for an installment note. The S corporation then develops and subdivides the land, and constructs improvements in the form of the condominium units.[10] For appearance sake and to

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[9] The Section 1239 related party rules do not apply to make the gain ordinary because land is not a depreciable asset to the purchasing S corporation.

Section 1239 states that gain on the sale of property between related persons is taxed at ordinary income rates if the property is depreciable in the hands of the related party transferee. Accordingly, if an apartment building is going to become condominiumized and is sold to an S corporation that does not depreciate the apartments and instead condominimizes the apartments, Section 1239(a) should not apply.

[10] An S corporation, rather than a partnership or LLC, is used as the development (continued...)

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make the transaction appear more bonafide, it is preferable that the buying S corporation not have the identical ownership of the selling partnership. The installment note, because of related party issues, should be on arm's-length terms and require a payment each time that a lot or condominium unit is sold.[11] To avoid a potential IRS challenge, it is helpful for the S corporation to be capitalized with more than a di minimis amount of cash.

Second, the installment note should have a specific due date (such as five years or less). The installment note should be secured by a deed of trust on the land and other financing formalities should be observed in order for the installment note to appear as a bona fide debt instrument for tax purposes.[12] The installment note amount should not be contingent on the sales price of the condominium units (or the lots), since this would make the installment note look like a "profit sharing arrangement," rather than a bonafide debt instrument. However, the timing of the installment note payments could be made contingent on the S corporation's sale of the condominium units (or lots), and may include partial "release" clauses of the deed of trust's lien as each condominium unit (or lot) is sold.

Third, the development activities (such as obtaining governmental subdivision entitlements and constructing the improvements) should be performed by the S corporation (and not by the selling partnership) as the developer. Separate books,

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[10](...continued)
entity because Section 707(b)(2)(B) states that gain on the sale of property between two related partnerships results in ordinary income if the property is ordinary income property in the hands of the purchasing partnership. A partnership could be used as the buyer (rather than an S corporation) if that transferee partnership is not controlled by the selling partnership, which would mean that the partners in the transferring partnership would have to own 50% or less of the transferee partnership.

[11] The sale to the S corporation must be bona fide and must shift the burdens and benefits of the land's ownership to the S corporation for the transaction to be recognized for tax purposes. See ***Phelan***, TC Memo 2004-206. The purchasing S corporation must not be classified as an "agent" of the selling partnership for tax purposes.

[12] The installment note principal amount limit of $5,000,000, before interest is paid on the deferred tax liability, may not apply since this threshold limit applies on a per-partner basis at the partner level. See Section 453A(b)(2).

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records, checking accounts and bank accounts should be maintained for the S corporation and for the partnership/seller.

Fourth, have a "business purpose" for establishing the S corporation as the developer, such as the need for different ownership and management by a separate corporation or the need of a separate developer corporation for liability protection.

Finally, the principal amount of the installment note should be low enough so that some part of the developed project's sales' gain (which is taxed at ordinary rates) is allocated to the S corporation in order to properly compensate the S corporation for its development activities. However, the amount of ordinary taxed gain which is allocated to the S corporation should not be overstated, since California imposes a 1½% state corporate level tax on S corporation earnings, and the S corporation income is then taxed at ordinary rates to its shareholders.

2.1 ***Avoiding the Section 351 Issue***. In the sale of the land to the related S corporation, the IRS may try to recharacterize for tax purposes the installment sale to the S corporation as a Section 351 capital contribution transaction where no gain is recognized. If the IRS is successful in this argument, then both the land's sale appreciation and the S corporation's development activities will be taxed at ordinary income tax rates. To avoid this IRS attack, the partnership's land's sale to the related S corporation should be structured so that the related S corporation is not owned by a "controlling interest" of the selling partners (which means that the selling partners should own less than 80% of the S corporation stock).

Section 351(a) states that gain or loss is not recognized by the property transfer by one or more persons to a corporation solely in exchange for stock if immediately after the property transfer such person is in control of the corporation. Controlling that S corporation would mean to own at least 80% of the total combined voting power and 80% of the total number of shares under Section 368(c). Therefore, if there are unrelated third parties owning more than 20% of the S corporation, the IRS cannot assert Section 351 treatment since there is no control.[13]

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[13] For purposes of determining control, Section 267(b) applies so that stock owned (continued...)

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2.2 ***Avoiding the Section 1239 Problem***. Section 1239 states that gain which is recognized on the sale of property between related persons will be taxed at ordinary income tax rates if the property sold is depreciable in the hands of the related buyer. A person is related for purposes of Section 1239 where that person and the other buying/selling entity is a "controlled" entity with respect to that person (which generally means where there is more than a 50% ownership by such person). [See Section 1239(b).]

Therefore, if the buying entity depreciates the purchased property (such as an apartment building), a solution to avoid Section 1239 is to have the buying entity being owned 50 percent or more by persons who are not related parties of the selling partnership. For example, the S corporation that buys the existing apartment building which is to be condominiumized could be owned in part by a real estate broker or the construction contractor who would receive the upside of the development activities in exchange for their services.

2.3 ***Be Sure That Installment Note Which is Received By the Partnership is Not Treated as a Second Class of S Corporation Stock***. S corporations may only have one class of stock (with the exception of voting and non-voting stock). Accordingly, the installment note should be structured so that it is a bonafide promissory note. The installment note must not be classified for tax purposes as equity, which would result in a second class of stock and which in turn would terminate the S corporation election. Additionally, a partnership is a prohibited S corporation shareholder. Terminating the S corporation election would cause the corporation to be taxed as a C corporation, resulting in a corporate level tax on the development activities.

2.4 ***Avoid the Interest Generated on the Installment Note (Which is Owed By the S Corporation to the Partnership) Creating Too Much Interest Income to the Partners***. If the installment note owed by the S corporation to the partnership runs for too long a time period, then the interest on that installment note (which is taxed as ordinary income to the partnership) will cause a significant amount of the profits being taxed at ordinary income

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[13](...continued)
by members of the transferor family, such that the stock ownership of their siblings or children would be attributable to the transferor.

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rates (rather than long-term capital gain rates). Accordingly, a realistic time line of the development process should be prepared which actually projects the amount of interest (which is taxed at ordinary income rates) that accrues on the installment note from the date of the partnership's land sale to the S corporation.

2.5 ***Other Section 453 Issues to Avoid***. Section 453(e)(1) states that if there is a sale of property to a related person, and if before the seller who made the first disposition has received all payments with respect to that first sale, the buying related party disposes of the property less than two years after the first disposition, then the amount realized with respect to the related buyer's second sale will be treated as received by the seller at the time of the buyer's second sale. This issue should not be a problem since the partnership/seller is willing to recognize gain as each condominium unit is sold, since payments will be made by the S corporation to the selling partnership as each condominium unit is sold.

The installment sale method is not available for the sale of depreciable property between related persons. [Section 453(g)(1).] Accordingly, the sale of land (being non-depreciable) would not be affected by this rule. Also, can avoid the application of Section 453(g)(1) by not having the partnership be related to the S corporation under Section 1239(b).

3. **PLANNING TECHNIQUE TO USE SECTION 1237 TO ACHIEVE CAPITAL GAIN TREATMENT FOR A CLIENT WHO SUBDIVIDES LAND INTO MULTIPLE LOTS, FOLLOWED BY THE CLIENT SELLING THESE SUBDIVIDED LOTS**.

In order for the client to not be classified as a dealer taxed at ordinary rates, and instead to receive long-term capital gain treatment, the client could utilize Section 1237. Section 1237 permits the client to receive long-term capital gain treatment when they subdivide land which meets the following requirements:

(a) The land must be held for no less than five years, except where the client inherited the property.

(b) The land must be subdivided into no more than five lots.

(c) The land must not be substantially improved by the client.

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(d) In order to qualify under Section 1237, the taxpayer may not have been a "dealer" in real estate with respect to the subdivided parcels of land in any year prior to their sale, and that taxpayer in the year of the lot's sale may not be a dealer with respect to any other real property.

Thus, the client can use Section 1237 to sell up to five subdivided lots to five different persons and still receive long-term capital gain treatment on the sale of these lots.[14]

Additionally, Section 1237 allows the client who holds land for at least 10 years to receive long-term capital gain treatment where that client only does infrastructure improvements (such as roads and utilities) for that land's subdivision. However, the costs of these infrastructure improvements cannot then be added to the land's tax basis.[15]

4. **CLIENT, WHILE STILL IN ESCROW TO PURCHASE A PARCEL OF PROPERTY, NOW WANTS TO SELL THAT PROPERTY TO A NEW BUYER AT LONG-TERM CAPITAL GAIN RATES.**

Many times a client who is in escrow to purchase a particular real property wants to sell that property while still in escrow and be taxed at lower long-term capital gain rates (rather than higher ordinary income tax rates). The client's dilemma is that the client must satisfy the one-year capital gain holding period requirement which states that the property's holding period commences on the date that the client closes that property's purchase escrow.

4.1 ***The Client Can Sell the Purchase Contract, Rather Than Selling the Underlying Real Estate.*** To satisfy this one-year holding period requirement, the client can engage in the following alternative tax strategy: the client sells the property's purchase contract (rather than selling the underlying property) to the buyer. The purchase contract is itself a capital asset for tax purposes since this purchase contract is for the purchase of real

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[14] If more than five subdivided lots are sold, then the gain for years in or after the year in which these additional lots are sold is taxed at ordinary rates to the extent of 5% of its selling price. Section 1237(b)(1).

[15] See Section 1237(b)(3).

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estate -- a capital asset.[16] This property's purchase contract's one-year holding period commenced on the date that the contract was signed (and not on the date that the property's purchase escrow closes). Therefore, the client receives long-term capital gain treatment on the contract's sale so long as the client sells this purchase contract more than one year after the client signed that purchase contract.

5. **THE CLIENT DOES NOT CURRENTLY RECOGNIZE GAIN ON DEPOSITS THE CLIENT RECEIVES**.

Clients can receive conditional cash deposits during a property's sale escrow period and not have to pay any tax on these received cash deposits until their sale escrow closes (at which time the client recognizes long-term capital gains on these previously received cash deposits).[17]

The tax rule is that a client only recognizes as income cash deposits when the client has an unconditional right to retain those deposits. Thus, when the property's sale closes, the client recognizes capital gain income. If the property's sale does not close, any deposit monies retained by the client are taxed at ordinary income tax rates.

6. **PLANNING TECHNIQUES TO AVOID THE PROBLEM OF A PARTNERSHIP DISTRIBUTING REAL PROPERTY TO THE PARTNERS, FOLLOWED IMMEDIATELY BY THOSE PARTNERS DOING A TAX-FREE EXCHANGE (SO-CALLED "DROP AND SWAP EXCHANGES")**.

It is common for partnerships that own real estate to be split up. The client may be splitting up real estate partnerships because of a business or family dispute. In many cases these partnership split-ups arise after many years of protracted litigation between the partners.

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[16] See ***William T. Gladden***, 112 TC 209 (1999); *rev'd* and *rem'd* on other issues 262 F3d 851 (9th Cir. 2001). Gain attributable to a sale of a right with respect to property is capital gain where that underlying property is a capital asset in the hands of the taxpayer. Also, see Section 1234(a)(1). Thus, under Section 1234(a), the sale of a real estate contract right is treated as the sale of a capital asset if the underlying real estate is a capital asset.

[17] See ***Jefferson Auto Parking Co.***, TC Memo 1963-266 and Section 1234(a)(1).

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When a partnership[18] desires to split up, the partnership sometimes first liquidates and distributes all of the partnership's Relinquished Property (the "Relinquished Property" is the property a taxpayer sells in an exchange) to its partners as tenants in common, followed by these former partners immediately selling that Relinquished Property. The selling former partners then attempt to do a Section 1031 tax-free exchange into different properties and some partners even receive cash. This arrangement, however, risks violating a basic requirement of Section 1031, which is that exchanging partners must "hold" both the replacement property ("Replacement Property" is the property a taxpayer exchanges into) and the Relinquished Property for "productive use in a trade or business or for investment." Although there is no specified length of time that the exchanging former partners must "hold" the Relinquished Property before entering into an exchange, the former partners should own the Relinquished Property as tenants-in-common long enough to evidence their intention to hold the Relinquished Property for investment, or trade or business purposes. The former partners want to hold the Relinquished Property long enough to be classified as a valid tenancy-in-common relationship after the liquidation of the Relinquished Property and not be classified as a continuing "partnership" for federal income tax purposes.

6.1 ***Dissolution and Liquidation of the Partnership, Immediately Followed By a Section 1031 Exchange of the Property***. The IRS has ruled that taxpayers did not "hold" the Relinquished Property for the required qualified use, where the property was received by the taxpayer as a liquidating distribution from a legal entity and then immediately exchanged for the Replacement Property.[19] Contrary to this IRS ruling, the Tax Court in ***Mason v. Commissioner***[20] held that exchanges by partners who received the Relinquished Property in a partnership liquidation qualified for tax-free exchange treatment. Similarly, in ***Bolker v.***

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[18] These tax rules also apply to limited liability companies.

[19] *See* Rev. Rul. 77-337, 1977-2 C.B. 305. This IRS position has recently been reaffirmed by the IRS in PLR 200651030 (released December 22, 2006).

[20] TC Memo 1988-273. ***Mason*** did not specifically address the Section 1031 "holding" requirement issue.

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Commissioner[21], the Ninth Circuit Court of Appeals held that shareholders qualified for tax-free exchange treatment even though the shareholders exchanged the Relinquished Property after they received that property in a corporate liquidation. The Ninth Circuit in ***Bolker*** held that Section 1031 only requires a taxpayer to own the Relinquished Property before entering into the exchange and to have no intent either to liquidate the Relinquished Property or to use the Relinquished Property for personal purposes.[22]

6.2 ***Planning Technique to First Liquidate the Partnership and Then the Former Partners Hold the Liquidated Relinquished Property as Tenants-In-Common Before Doing an Exchange***. A safer tax strategy is to have the former partners hold their tenant-in-common interests in the Relinquished Property (after the partnership liquidates) for an extended time period before they exchange those interests for the Replacement Property. However, for tax purposes the former partners' tenancy-in-common relationship must be structured so as not to be treated as a partnership for tax purposes.[23] Thus, the formalities of a tenancy-

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[21] 760 F2d 1039 (9th Cir. 1985). In ***Bolker***, the corporation liquidated under former Section 333 followed by the shareholders entering into an exchange of the liquidated property.

[22] Taxpayers who desire to split up partnerships must also be aware that the IRS could attack the "swap and drop" transaction or similar split-up transactions under a step-transaction doctrine. In a step-transaction, if the steps are in substance integrated and focused to a particular result, then the tax significance of each of the separate steps is ignored, and instead the tax consequences of the step transaction as a whole is considered. The step transaction was utilized in ***Crenshaw***, 450 F2d 472 (5th Cir. 1971), to find that a transaction did not qualify as a Section 1031 exchange where the taxpayer exchanged the property shortly after the taxpayer acquired the property in a partnership distribution.

The IRS may also attack a drop-and-swap transaction under a "substance-over-form" argument as it successfully did in ***Chase***, 92 TC 874 (1989).

[23] The Regulations allow a co-tenancy to avoid being classified as a partnership if the co-tenancy is simply maintaining, repairing and renting the property. *See* Treas. Regs. Section 301.7701-1(a)(2). Management activities by the co-tenancy should be limited as much as possible in order that the relationship does not rise to a business relationship

(continued...)

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in-common relationship should be observed. To formalize the appearance of a tenancy-in-common, the individual tenants-in-common names should be titled on the property's deed, and the partnership's liquidation should be legally formalized by filing the requisite state dissolution and termination documents, such as a Form LP-3 Certificate of Dissolution for liquidating California limited partnerships.[24]

6.3 ***Planning Technique For the Partnership To First Do the Exchanges Into the New Properties, Followed By a Distribution of the Properties to the Former Partners***. An alternative solution is that the partnership first completes the Section 1031 tax-free exchanges at the partnership level into multiple Replacement Properties. Second, the partnership then liquidates and distributes each Replacement Property to a specific group of partners. This alternative solution has several issues which must be addressed. First, the IRS may argue that the distributed Replacement Property was not held after the exchange for investment purposes since it was immediately distributed out of the partnership. Second, since many exchanges utilize the Section 1031 deferred exchange 45-day identification rules, there will be limits on the number of identified Replacement Properties. Accordingly, the limitation on the number of alternative Replacement Properties may prevent this alternative solution from working.

6.4 ***IRS Guidelines On How to Be Classified as a Tenancy-in-Common and Not as a Partnership For Tax Purposes***. The IRS issued Rev. Proc. 2002-22 to list the conditions under which the IRS will consider a revenue ruling request that a tenancy-in-common interest (sometimes known as a "TIC") will not be treated as a partnership interest for tax purposes under Section 7701 (in order to qualify

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[23](...continued)
resulting in partnership tax status. There should be a written co-tenancy agreement which preserves the normal rights of a co-tenancy under state law.

[24] For an example on how not to create a valid co-tenancy relationship, *see* ***Chase v. Commissioner***, 92 TC 874 (1989), where the tenant-in-common did not execute the sale's escrow agreement, and the partnership continued to manage the property and allocate economic benefits as though the tenancy-in-common distribution had not occurred.

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for Section 1031 purposes).[25] Revenue Procedure 2002-22 states that its conditions are "not intended to be substantive rules and are not to be used for audit purposes," and are only a list of items to be complied with in order to obtain a favorable IRS revenue ruling.[26]

7. **<u>PLANNING TECHNIQUES TO CASH OUT PARTNERS WHERE THE PARTNERSHIP ENGAGES IN A TAX-FREE EXCHANGE</u>**.

Commonly, real estate partnerships desire to split up with certain partners receiving cash (referred to as the "cash-out partners"), and the remaining partners exchange tax-free into other real estate. To achieve these dual goals, partnerships sometimes sell their real estate and use a portion of the sales proceeds to exchange tax-free into other real estate, while simultaneously distributing cash to the cash-out partners in full redemption of the cash-out partners' partnership interests. The partnership's intent is only for the cash-out partners to report taxable gain proportionate to the sales proceeds which they receive and for the remaining partners in the exchanging partnership to receive tax-free exchange treatment. However, distributing cash to only the cash-out partners may result in all of the partners (including the remaining partners who desire to receive tax-free exchange treatment) being taxed on the sale's recognized gain if the partnership agreement allocates gain to all partners in proportion to their percentage interests.

7.1 ***<u>Special Allocations of the Partnership's Gain to the Cash-out Partners</u>***. Partners may consider amending their the

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[25] Rev. Proc. 2002-22 was issued in response to the real estate syndication industry that markets tenancy-in-common interests in large real estate properties to persons needing Replacement Property to complete their Section 1031 exchanges.

[26] Because of the uncertainty of when a tenancy-in-common becomes a partnership for tax purposes, IRS field agents are likely to defer to this Revenue Procedure's listed conditions on audit. Nonetheless, many tax advisors feel that violating certain items of Rev. Proc. 2002-22 does not automatically trigger partnership classification. As a practical matter, Rev. Proc. 2002-22 provides guidelines for structuring TICs which are acquired as Replacement Property in like-kind exchanges. The IRS is currently re-examining Rev. Proc. 2002-22 and may in the future issue new guidelines on tenancy-in-common relationships.

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partnership agreement to specially allocate all of the gain on a property's sale to only the cash-out partners, and none of the gain to the remaining partners who do a Section 1031 exchange. However, this special gain allocation is likely to fail Section 704(b)'s substantial economic effect test, because the special gain allocation would have to be reflected in the cashed-out partners' capital accounts, which in turn could alter the economic deal among the partners.[27]

7.2 ***Planning Technique to Redeem the Cash-out Partners' Partnership Interests For Cash Prior to the Exchange***. Prior to the Relinquished Property's sale, the partnership can fully redeem the cash-out partners' partnership interests using existing partnership cash reserves. The partnership can then exchange the Relinquished Property for the Replacement Property in a qualifying tax-free exchange.

7.3 ***Planning Technique to Have the Cash-out Partners Receive a Promissory Note in the Exchange***. An alternative tax structure is for the partnership to sell the Relinquished Property for cash and a promissory note. After the Relinquished Property's sale, the cash-out partners receive a distribution of the promissory note in exchange for the redemption of their partnership interests. The promissory note is structured to pay the cash-out partners principal and interest in the year of the exchange and in the following calendar year.[28] Thus, only those partners (who are the cash-out partners) who receive a distribution of the promissory note will have to recognize gain. Those partners desiring to receive tax-free exchange treatment then continue as partners in the partnership and have the partnership use their share of the property's sales proceeds to engage in a Section 1031 tax-free exchange. In a typical transaction, substantially all of the promissory note is repaid a short time after the close of the

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[27] For a further discussion, see **Real Property Exchanges**, 3rd Ed., California Continuing Education of the Bar, pp. 455-458.

[28] If an installment promissory note is received in a Section 1031 exchange, then any gain recognized is deferred under the installment method of reporting until the note payment is received. The distribution of the promissory note to the partners will not accelerate the note's gain under Section 453, since Treas. Regs. Section 1.453-9(c)(2) states that a partner's receipt of an installment note in a Section 731 distribution does not result in gain under Section 453B.

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Relinquished Property's sale, with the remaining payments (sometimes three percent or less of the promissory note's principal amount) made shortly after the beginning of the immediately next tax year, in order to qualify for installment sale treatment under Section 453(b)(1).

The distribution of the promissory note[29] to the cash-out partners will not trigger recognized gain to the partnership nor to those partners until they receive payments. [See Sections 453 and 731.][30]

7.4 ***Planning Technique of Having the Partnership Distribute a Fractional Tenancy-In-Common Interest in the Relinquished Property to the Cash-Out Partners Prior to the Exchange***. Another alternative tax structure is as follows: First, the partnership distributes a fractional tenancy-in-common portion of the partnership's Relinquished Property to the cash-out partners in redemption of the cash-out partners' partnership interests. Second, the cash-out partners and the partnership (which have become tenancy-in-common owners of the Relinquished Property) then engage in a sale of the Relinquished Property. In the sale, the cash-out partners retain their cash sales proceeds (and report the sale's gain thereon), while the partnership uses its portion of the Relinquished Property's sales proceeds to enter into a tax-free exchange.

The above tenancy-in-common relationship must be structured so as not to be treated as a continuation of the former partnership for income tax purposes. The Section 1031 requirement that the tenants in common hold the Relinquished Property for use in a trade

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[29] A concern with using this installment promissory note tax planning strategy is that if the buyer of the Relinquished Property has a weak credit rating, there may be a hesitancy by the partner/seller to accept the buyer's promissory note. However, one way to overcome a poor credit-rated buyer is to have that buyer deliver to the seller a standby letter of credit as further collateral. A standby letter of credit is not treated as a payment received under Temp. Reg. Section 15A.453-1(b)(3)(i).

[30] For Section 751 purposes, "unrealized receivables" are defined under Regs. Section 1.751-1(c)(1) as rights to payment for property other than a capital asset. Accordingly, an installment note sale of a capital or Section 1231 asset, and its distribution by the partnership, would not be subject to Section 751(a), except perhaps to the extent gain on a Section 1231 asset is treated as ordinary income.

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or business or for investment should not be an issue since the partnership, which always owned and held the Relinquished Property, will be doing the Section 1031 exchange.

8. **DIVIDING UP REAL ESTATE PARTNERSHIPS BY DOING A TAX-FREE PARTNERSHIP DIVISION, FOLLOWED BY A SALE OR TAX-FREE EXCHANGE OF THE UNDERLYING REAL ESTATE**.

Many times different groups of partners in real estate partnerships want to sell the partnership's properties, followed by each group of partners exchanging into their own separate properties (or in some cases one group of partners may want to cash out of the partnership). These dual goals can be accomplished by a tax-free division of the original partnership under Section 708(b)(2)(B).

The original partnership can be divided tax free into two or more new partnerships where each set of partners in each new partnership owned more than 50% in the capital and profits of the original partnership. [Section 708(b)(2)(B).]

8.1 ***In a Tax-free Partnership Division Argue That Each New Partnership Has the Section 1031 "Holding" Tax Attribute of the Former Partnership***. The IRS in 1982 issued PLR 824412 which states that where a partnership divides into two "continuing" partnerships, both continuing partnerships may reinvest Section 1033 condemnation proceeds. Arguably, PLR 824412's tax principles should also apply to Section 1031. Thus, each partnership in a qualifying division under Section 708(b)(2)(B) is arguably a continuation of the former partnership for Section 1031 purposes. The Section 1031 analysis is that the resulting partnerships have "held" for investment the respective former partnership's real properties. Thus, by analogy to the Section 1033 rules, argue that where a partnership splits into two partnerships under Section 708, both resulting partnerships are a continuation for Section 1031 purposes of the former partnership.

8.2 ***Treasury Regulations on Partnership Divisions***. Treasury Regulation Section 1.708-1(d)(3)(i) states that an "assets-over-form" partnership division is where the existing partnership transfers some or a portion of its assets to a new partnership and such new partnership interests are then distributed to the existing partnership's partners. The "resulting partnerships" from this partnership division must have at least two partners who were

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partners in the prior existing partnership. These resulting partnerships are then deemed to be a continuation of the prior existing partnership.[31]

9. **PLANNING TECHNIQUE OF USING THE PARTNERSHIP TAX-FREE DIVISION RULES TO DIVIDE UP MULTIPLE PARTNERSHIPS OWNED BY THE SAME PARTNERS.**

> **Example: Assume that there are two groups of partners, Group A and Group B. The Group A and Group B partners own interests in various real estate partnerships, which partnerships in turn own different buildings. Because of a business dispute, the Group A and Group B partners desire to split with each other, and not to own partnerships together. Accordingly, the Group A and Group B partners decide to do a tax-free partnership division under Section 708 as follows:**

(a) First, each existing partnership (which is owned jointly by Group A and Group B partners) transfers its respective property to a single-member LLC. Thus, each existing partnership owns 100% of the membership interests in the single member LLC, which LLC in turn owns the underlying building.

(b) Second, the Group A and Group B partners then transfer all of their partnership interests in each partnership (which each partnership continues to own its respective single member LLC) to a "Master Mother Partnership" in exchange for a partnership interest in the Master Mother Partnership.

(c) Third, the Master Mother Partnership then liquidates each partnership so that the Master Mother Partnership owns directly all of the single member LLC membership interests. The Master Mother Partnership then owns 100 percent of the membership interests of each single member LLC (and each LLC in turn continues to own its respective building).

(d) Fourth, the Master Mother Partnership after two years then distributes 100% of the membership interest in specific single member LLCs (and each LLC continues to own its respective buildings) to the Group A partners and distributes the other single

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[31] Treas. Reg. Section 1.708-1(d)(2).

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member LLCs (with their underlying owned building) to the Group B partners. The Master Mother Partnership must wait at least two years under Section 707(a)(2)(B) to do these LLC membership interest distributions in order to avoid the disguised sale rules. Additionally, to avoid the disguised sales rules, there should not be a preplanned agreement to split the LLCs by distributing them after the two-year period. Rather, the distribution should simply occur after the two-year period.

(e) Fifth, when the contribution of the LLCs is made to the Master Mother Partnership, the subsequent Master Mother Partnership LLC distribution (to the Group A and Group B partners) is treated as a "assets-over-form" division under the tax-free partnership division rules of Section 708(b)(1)(B). For tax reporting purposes, the Master Mother Partnership is treated during the two-year holding period as a "continuation" of that single member LLC that has contributed the most net assets. There is no partnership "termination" and no depreciation restart because of the Section 708 partnership division rules.

(f) Finally, because the partnership's division Regulations under Section 708 indicate that this structure is an "assets-over-form," the anti-mixing bowl rules contained in Sections 704(c) and 737 should not apply. Each LLC can then proceed to sell its respective real property and enter into a tax-free Section 1031 exchange. The reason the anti-mixing bowl rules do not apply is because of the exception for "assets-over-form" partnership divisions stated in Regulations Sections 1.704-4(c)(4) and 1.737-2(b).

10. **PLANNING TECHNIQUE OF CLIENTS HAVING THEIR REAL ESTATE PARTNERSHIP INTERESTS REDEEMED IN ORDER TO AVOID BEING TAXED AT THE HIGHER 25% RECAPTURE TAX RATE**.

When real property is sold, the prior depreciation and amortization deductions will be "recaptured" and taxed at the higher 25% Federal recapture tax rate, rather than the lower 15% maximum federal capital gain rate.[32] Where real property is owned in a partnership, this 25% tax can be avoided by the client as follows: the partnership redeem the client's partnership interest (rather than the partnership selling the underlying real property),

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[32] See Sections 1250 and 1(h)(6)(A).

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resulting in the client's entire redemption gain being taxed at lower long-term capital gain rates.[33] Of course, the remaining partners continue to own their partnership interests with this recapture amount remaining in the partnership.

11. **CLIENT DESIRES TO SELL PARTIALLY COMPLETED IMPROVEMENTS AT LONG-TERM CAPITAL GAIN RATES**.

Clients who commence constructing a building on land which the client has owned for several years may find a buyer before the client finalizes constructing that building. If the client were to sell the land and building during the construction process and then close the sale escrow shortly after the building improvements are completed, the building improvements' one-year capital gain holding period commences upon those improvements' date of completion. Thus, the tax result for these newly completed improvements would be short-term capital gain treatment taxable at ordinary income tax rates.

Where the client has owned the land for more than one year, the land's sale gain can still be taxed at long-term capital gain rates (even if the building improvements are not completed by the closing of the sale). Additionally, the "cost" of those building improvements which are completed one year before the sale are also taxed at lower long-term capital gain rates.[34]

Therefore, in addition to the land and improvements having different holding periods, different portions of the constructed real estate can have different holding periods. Improvements which are completed before the beginning of the one-year long-term capital gain holding period will receive long-term capital gain treatment, while those improvements that are completed after the

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[33] See Treas. Regs. Section 1.1(h)-1(b)(3)(ii) which states that the rules of the 25% recapture tax will not apply in a redemption of a partnership interest.

[34] See ***Russo***, 68 TC 135 (1977), and Rev. Rul. 75-524, 1975-2 CB 342. The client should have an appraisal prepared to prove the "cost" of these building improvements which were completed one year before their sale.

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commencement of the one-year long-term capital gain holding period will receive short-term capital gain treatment.[35]

12. **PLANNING TECHNIQUES USING UPREITS TO SELL REAL ESTATE**.

An UPREIT is a structure by which a real estate seller can transfer real estate to a limited partnership (known as an "Operating Partnership" or an "OP") and receive back units in the Operating Partnership which can at a later date be converted to real estate investment trust interests. The real estate investment trust interests are generally traded on a public national stock exchange.

Real estate investment trusts (known as "REITs") are organized as either corporations, trusts or associations, and must meet certain specific tax law requirements.[36] In order to elect REIT status, the REIT cannot be closely held, which generally means five or fewer individual cannot own 50% or more of the REIT stock. Thus, a REIT cannot be formed by a few investors. A REIT will not be subject to taxation at the entity level to the extent the REIT income is distributed to the REIT shareholders. In today's real estate market, a large amount of commercial real estate has been transferred into REIT ownership.

In an UPREIT transaction, substantially all of the assets of the REIT are owned by the Operating Partnership. This type of structure is sometimes referred to as an "umbrella partnership real estate investment trust." The REIT is the general partner of this Operating Partnership and there are limited partners of the Operating Partnership. The Operating Partnership issues limited partner interests to real estate owners who contribute their real estate to the Operating Partnership. The limited partners are given the right to exchange their Operating Partnership interests for REIT common stock at a later date.[37]

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[35] See ***Aagaard***, 56 TC 191 (1971), *acq*. 1971-2 C.B. 1.

[36] See Section 856. A REIT has restrictions on the types of assets it may own.

[37] In some cases the REIT may have the right to elect to pay cash to the converting Operating Partnership's limited partners, instead of giving the limited partners REIT stock.

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12.1 ***Tax Result to the Contributing Limited Partners***. The UPREIT structure allows existing owners of real estate to contribute their real estate tax free to the Operating Partnership and receive back limited partnership interests (which are convertible into REIT stock). The contributing limited partners are able to defer their taxable gain on their real estate and are able to diversify their real estate holdings by sharing the risk with other contributing limited partners who also contribute their real estate to this same Operating Partnership.[38]

12.2 ***Section 704(c) Tax Issue to Contributing Limited Partners***. The limited partners who contribute their real estate to the Operating Partnership in exchange for limited partnership interests in the Operating Partnership will generally have a low tax basis in their contributed real estate and in their Operating Partnership limited partner interests which they receive back. These partners need to have covenants with the REIT that their contributed real property will not be sold by the Operating Partnership for a specified time period in order that these contributing partners can avoid recognizing the built-in gain (and resulting tax) under Section 704(c). Accordingly, it is common for the contributing partners to receive from the REIT a written covenant that the REIT will not sell the contributed property for five to 15 years (sometimes referred to as a "lock-out period"). Also, the contributing partners must negotiate which Section 704(c) method the REIT will elect -- the traditional method, the curative method, or the remedial method.

12.3 ***Allocation of Debt For Tax Purposes***. When the contributing partners contribute their real estate to the Operating Partnership, many times that contributed real estate will be encumbered by deeds of trust or other indebtedness. Accordingly, the contributing partners are relying upon an allocation for tax purposes of enough debt from the Operating Partnership in order to not have a deemed distribution and gain recognition. Therefore, the contributing partners will want the Operating Partnership to covenant that the Operating Partnership will not refinance or restructure the Operating Partnership's debt so as to trigger a recognition event to the contributing partners. Additionally, the

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[38] In addition to the limited partners who contribute real estate to the Operating Partnership, the parent REIT may also have cash investors who are persons who have purchased directly stock interests in the REIT.

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contributing partners might negotiate a tax indemnification from the REIT for a specified period of years which states that if the Operating Partnership engages in a refinancing or debt restructuring that triggers gain to the contributing partners (or engages in certain other specified acts which trigger taxable gain to the contributing partners), then the Operating Partnership will indemnify the contributing partners for the amount of the tax on this gain (and the "tax on the tax").

12.4 ***Converting the Limited Partnership Interest in the Operating Partnership Into REIT Stock***. When the contributing partners exercise their right to convert their Operating Partnership limited partner interests into REIT stock, there is a taxable event. Gain at the time of conversion is recognized in the amount of the difference between the then fair market value of the REIT shares over the converting partner's adjusted outside tax basis of their Operating Partnership interests.

One tax issue is that the exchange of the Operating Partnership limited partner interests for REIT shares within two years of the contribution of the real estate to the Operating Partnership might presumptively be treated as a "disguised sale" by the contributing partner under the Section 707 disguised sales rules. Under the disguised sale rule, where there is a transfer of the property from the partner to the Operating Partnership and then that same partner later receives either cash or other consideration in the form of REIT stock (when that partner elects to convert its Operating Partnership interest into REIT Stock), a sale of the property could be deemed to have occurred under the Section 707 "facts and circumstances test." [See Treas. Reg. Section 1.707-3(b).] A disguised sale would mean that the contributing partner did an installment sale on the date that the partner contributed its real estate to the Operating Partnership (rather than recognizing gain on receiving the REIT shares).

12.5 ***What is a DOWNREIT Structure***? In a DOWNREIT, the contributed real estate of the REIT is not owned through one single Operating Partnership. Instead, in a DOWNREIT, the REIT forms multiple subsidiary partnerships for different real estate owners who then contribute their respective real properties to their separate subsidiary partnership owned by the REIT.

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13. **PLANNING TECHNIQUES TO RECEIVE PARTNERSHIP DISTRIBUTION OF REAL ESTATE TAX-FREE INSTEAD OF SELLING THE REAL ESTATE FOR CASH**.

Many times real estate is owned in partnership or LLC form. The partners (or LLC members) wish to sell this real estate and receive cash tax free. Alternatively, the partners may wish to receive other property in exchange for such real estate, and cannot satisfy the deferred exchange rules of Section 1031.

13.1 ***Avoiding the Disguised Sale Rules of Section 707(a)(2)(B)***. Section 707(a)(2)(B) states that if there is a transfer of money or other property by a partner to a partnership and there is a related transfer of money or other property by the partnership to such partner (or another partner), then the transfers will be treated as occurring between the partnership and person who is not a partner if, when viewed together, the transfers are properly characterized as a sale or exchange of property. Treasury Regulations have been issue to interpret this provision, including stating that there is a presumption that if the transfer of property and receipt of cash occurs within a two-year period, there is a presumption of a disguised sale. These Regulations provide safe harbor distributions, even if these distributions of cash are within the two-year period, such as distributions of partnership operating cash flow, reimbursement for certain expenditures, and specified returns on contributed capital.

(a) ***Two-Year Presumption***. The Treasury Regulations provide that if within a two-year period there is a contribution of property by one partner to the partnership and a distribution of property to another partner, the transfers are presumed to be a sale of property (by the first contributing partner) to the partnership. [Regs. Section 1.707-3(c)(1).] This presumption is rebutable only if "the facts and circumstances clearly establish that the transfers do not constitute a sale." The Regulations contain a list of ten factors that tend to prove the existence of a sale, such as that the transferor has a legally enforceable right to the subsequent transfer. Accordingly, clients should not enter into a contract binding the partnership to make a transfer two years and one day after the transfer of property by one partner to the partnership and a transfer of cash by another partner to the partnership, that the cash will later be distributed to the first partner.

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(b) <u>Example</u>: Partner A on day one contributes to the partnership real property with a value of $1,000,000, and Partner B on day one contributes to the partnership $1,000,000 in cash. Two and one-half years later, $333,000 of cash is distributed to partner A. The result is that under the Treasury Regulations it is presumed that partner A has <u>not</u> sold its previously contributed property to partner B. If, however, $333,000 of cash was distributed to partner A one year after the property contribution by A, then there would be presumption of a disguised sale by A.

13.2 ***<u>Anti-Mixing Bowl Rule of Section 704(c)</u>***. Section 704(c)(1)(B) states that if a partnership either directly or indirectly <u>distributes 704(c) property to any partner</u> (other than the contributing partner) <u>within seven years</u> of that 704(c)'s property's contribution to the partnership, then the contributing partner must recognize gain or loss as if that 704(c) property had been sold for its fair market value at the time of the distribution. The character of such gain or loss is determined by the reference to the character of the gain or loss which would have resulted if such property has been sold by the partnership to the distributee partner, and appropriate adjustments are made to the adjusted basis of the contributing partner's partnership interest and to the adjusted basis of the distributed property in order to reflect any gain or loss recognized by Section 704(c)(1)(B).[39]

These Section 704(c) rules apply where a partner contributes property to a partnership and then that same property is distributed to another partner within seven years. This second distribution causes the contributing partner to recognize any of the property's remaining built-in gain under Section 704(c)(1)(A).

13.3 ***<u>Anti-Mixing Bowl Rule of Section 737</u>***. Section 737 states that a partner who contributes Section 704(c) property to a partnership and then receives a <u>distribution of other property</u> (other than money) from that partnership within seven years of the partner's property contribution, that <u>contributing partner</u> will recognize gain equal to the lesser of: (i) the excess (if any) of

[39] Property is 704(c) property if at the time of the property's contribution, the book value of such property is different from the contributing partner's adjusted tax basis in that property. [See Treas. Regs. Section 1.704-3(a)(3)(i).]

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the fair market value of property received in the later distribution over the adjusted basis of such partner's interest in the partnership immediately before the distribution reduced (but not below zero) by the amount of money received in the distribution; or (ii) the net pre-contribution 704(c) property gain of that partner. Any gain recognized under Section 737 is in addition to the gain recognized under Section 731. The character of the gain is determined by reference to the proportion character of the net pre-contribution gain.

> **Example: Partner A contributes an office building to the partnership and partner B contributes $10,000,000 of cash which is then used by the Partnership to buy an apartment building. Within seven years of partner A's contribution of the office building, the apartment building is distributed to partner A. Under Section 737, partner A must recognize gain equal to the lesser of the remaining built-in Section 704(c) built-in gain on the office building (which partner A previously contributed to the partnership), or the excess of the fair market value of the apartment building (which partner A receives as a distribution) over partner A's outside tax basis of its partnership interest.**

13.4 ***Planning Techniques to Receive Real Estate Tax Free From a Partnership***. The above partnership tax rules necessitate careful tax planning in order to engage in so-called partnership "mixing bowl" transactions.

> **Example: Assume that a partnership's four equal partners (known as the "Old Partners") desire to sell the partnership's sole asset, an Office Building, but do not yet have a property they desire to exchange into. Assume that the partnership had originally purchased the Office Building five years ago. A new group of partners (the "New Partners") who desire to acquire the Office Building contribute $10,000,000 to the partnership. Each of the four Old Partners then has the right to utilize $2,500,000 (one-fourth of the $10,000,000) to designate a new property ("New Property") that the partnership will purchase in the future to be credited to such designated Old Partner.**

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(a) The partnership must avoid the disguised sale rules of Regs. Section 1.707-3(f) example 8. Could have the four Old Partners receive approximately 95 percent of the distributions and tax items of their respective designated New Property (with the New Partners receiving the remaining five percent). The New Partners would receive approximately 95 percent of such distributions and tax items of the Office Building (and the Old Partners receive the remaining five percent of the Office Building).

(b) The Old Partners are then given an option to have the partnership in the future redeem their partnership interests for their respective designated New Property.

(c) Because the Old Partners did not contribute the Office Building to the partnership, the anti-mixing bowl rules of Section 737(b) would not apply. Similarly, the Section 704(c)(1)(B) anti-mixing bowl rules should not apply because the Office Building was not contributed to the partnership and is not being distributed to another partner.

(d) However, the Proposed Treasury Regulations' disguised sales rules of partnership interests of Section 707(a)(2)(B) may apply since the New Partners are transferring property (in the form of $10,000,000 of cash) to the partnership, and the Old Partners are receiving their respective New Property in distribution for redemption of the Old Partners' partnership interests (i.e., a "disguised sale"). The Proposed Treasury Regulations treat contributions to the partnership of (i.e., the $10,000,000 by the New Partners) and the distributions of the New Properties to the Old Partners in complete redemption of the Old Partners' partnership interests as disguised sales of the Old Partners' partnership interests. Thus, under Prop. Reg. Section 1.707-7(a)(1) the Old Partners may be viewed as having sold (by redemption) their partnership interests.

These partnership interest Proposed Treasury Regulations apply a similar 10 factor test as the Section 707 partnership property sales rules, and also indicate that if the transfer of the consideration (i.e. the contributed $10,000,000 by the New Partners) to the partnership and the partnership's transfer of consideration (i.e. the New Properties to the Old Partners) takes place within a two-year period, then the two transfers are presumed to be a sale of the Old Partners' partnership interests. See Prop. Reg. Section 1.707-7(c).

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Therefore, if these new Proposed Treasury Regulations apply, consider a tax plan to have the New Properties distributed to the Old Partners after the two-year presumption period, and do not have a legally enforceable right in the Old Partners to be transferred the New Properties under the facts and circumstances test of Prop. Reg. Section 1.707-7(b)(2).

These Proposed Regulations on disguised partnership interest sales are effective only for transactions which are part of a sale occurring on or after the date that these Regulations become final. [Prop. Reg. Section 1.707-9(a).]

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