

Partnership Installment Note (PIN)

A Solution for Some Partnerships in 1031 Exchanges

1031

Knowledge

A common problem occurs when a partnership (or LLC taxed as a partnership) plans to sell an investment property and some partners want cash while others want to defer taxable gain by having the partnership complete a Section 1031 exchange. If the partnership disposes of its property by taking some cash at the closing of the relinquished property sale for distribution to those who want to “cash-out” and placing the balance of cash from closing with a Section 1031 qualified intermediary, it’s likely that the partners wanting to exchange will still be allocated taxable gain. This is the fact pattern that sometimes gives rise to a transaction commonly referred to as a “drop and swap,” where the partnership distributes tenancy-in-common interests in the relinquished property to some or all partners before the sale, hoping that this will allow each former partner to treat the transfer of the resulting tenancy-in-common interest as a separate transaction.

A number of technical and practical issues arise when a partnership attempts a drop and swap transaction, creating the need for alternatives. One attractive option involves the conversion of the cash intended to go to cash-out partners into an installment note. This allows the partnership to avoid recognizing gain and allows all gain associated with the installment note amount to be allocated to those willing and planning to take it, namely the cash-out partners to whom the note is transferred in complete redemption of their interests in the partnership. We refer to this as a Partnership Installment Note transaction, or PIN transaction. So long as a valid installment note is received as “boot” in a PIN transaction where the selling partnership also completes a Section 1031 exchange, the gain represented by the note is taxed only when principal payments on the note are received. This would be after the note is transferred to, and is held only by, the cash-out partners. Since Treasury Regulations provide that a Section 1031 qualified intermediary is expressly regarded as the transferee of an exchanger’s property in a properly structured exchange, we believe that the qualified intermediary is able to deliver a valid installment note (which must come from the buyer of property).

In many cases, a PIN transaction can offer a very effective solution to a partnership planning to sell property where some partners want cash and others want tax deferral in a 1031 exchange. Even where a partnership has already signed a contract to sell property, which some advisors think is an event that adds significant risk to a “drop and swap” transaction, or where a property distribution would violate loan covenants, the PIN option may be available. As with most solutions, there may be circumstances where the solution isn’t appropriate, such as when the partnership percentage interest of cash-out partners is relatively high, or where the partnership’s property has a high debt-to-equity ratio. Further, the cash-out partners must be willing to wait for at least a short period of time after the relinquished property closing to receive any funds, and until the beginning of the year following the closing to receive at least a portion of the funds. However, partners and their advisors who face the scenario described should definitely consider the PIN option among other alternatives available to them.

Compliments of:



HQ 800.282.1031 | NY 866.394.1031
apiexchange.com | info@apiexchange.com

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