

**MANDATORY SALES OF JOINT OWNERSHIP PROPERTY UNDER
THE REVISED UNIFORM PARTNERSHIP ACT**

David J. Dietrich

A. Introduction

Clients may own real estate in tenancy in common fractional interests often as a result of inheritance or the dissolution of a business entity and frequently without a tenancy in common or partnership agreement. If held without an agreement, the default rules of the 1997 Uniform Partnership Act (“RUPA”) may apply. Upon a co-owner’s death, the surviving joint owner and the deceased owner’s estate may need guidance as to the remedies available for buyout, valuation or partition. This article reviews the common law of partition and RUPA, and the valuation, sale or purchase of a co-tenancy interest.

Whether common law partition or partnership dissolution applies is critical because (1) the rules for buyout and valuation differ radically under state partition schemes and RUPA and (2) the sale of a tenancy in common interest may qualify for tax deferral treatment under IRC 1031 while the sale of a partnership interest does not. *See* IRC 1031(a)(2)(D).¹

B. Buyout or Dissolution of a Deceased Joint Owners Interest: The Gibbs Ranch

Ned and Roger Gibbs, brothers, ages 75 and 77 respectively, began a working cattle ranch in 1954 in the Big Sky Country. They have “parlayed” their original 2,000 acre ranch into a 20,000 acre “spread.” Since the early 1960s, the Gibbs brothers have filed federal and state partnership tax returns. They have used cattle sale proceeds for partnership expenses, draws and to acquire the additional 18,000 acres over the years. They have ignored advice to form a limited

¹ Non-recognition is available only if the partnership itself elects to acquire replacement property IRC 1033. Whether an organization for tax purposes is an entity separate from its owners is a matter of federal law and does not depend on whether the entity is recognized under local law. *Treas. Reg. 301.7701-1(a)(2)*. *Rev. Proc. 2003-22* sets

partnership or limited liability company, or to execute a partnership agreement. Deeds to the 18,000 acres of real property are variously titled “Ned and Roger Gibbs”, “Ned and Roger Gibbs, Tenants in Common”, “Ned and Roger Gibbs, Joint Tenants With Rights of Survivorship”, and “Ned and Roger Gibbs, Gibbs Brothers Partnership.” The real estate is worth \$300 per acre or ten million dollars (\$6,000,000).

Ned died three weeks ago and Roger, the surviving partner, is in your office. Roger has received an angry call from Ned’s son, David, a divorce lawyer from Los Angeles, who stated that it was “time to split up” the ranch which he has always insisted was half his. Roger, on the other hand, would like to form a new partnership with his son Larry and keep the ranch intact.

The property is capable of physical partition, with evenly located water resources and road access. David has already devised a partition proposal that evenly divides the property.

1. Must David sell out to surviving uncle Roger or can David cause a partition of the real estate?
2. What are the federal estate tax discounts available for Ned’s estate?

C. Overview of Partition Law

Partition means the division of land held in co-tenancy into the co-tenants’ respective fractional shares. If the land cannot be fairly divided, then the entire estate may be sold and the proceeds appropriately divided. Every co-tenant has the right to compel partition, but that right may be modified or eliminated by the co-tenants’ agreements or acts. POWELL ON REAL PROPERTY § 50.07[1] (Matthew Bender & Co., Inc. Rel.91—6/00). Forty-six states have enacted statutes governing the partition of co-tenancy real property. *Id.* at § 50.07[1] n. 4.

out the criteria used by the IRS to issue letter rulings on whether rental tenancy in common real estate will be respected as a real estate interest or a partnership interest.

Co-tenants can agree to private partition by (a) written agreement of all the co-tenants, (b) by an exchange of deeds that dissolves the co-tenancy, (c) by ratification of a co-tenant's earlier conveyance of part of the land to an outsider or (d) by taking exclusive possession after an oral agreement to partition. *Id.* at § 50.07[2]. Barring such agreements or circumstances, however, the right to partition is virtually unconditional. *Id.* at § 50.07[3][a]. Partition is not barred by the minority of a party, the existence of encumbrances on a co-tenants' share or the homestead rights held by one co-tenant. *Id.* Nor is partition prevented by an outstanding lease of the co-tenancy property or a lien or encumbrance on the property. *Id.* at § 50.07[3][b].

Partition in kind (by physical division) is the preferred method of partition unless the co-tenants agree to a partition sale or that a physical division is impracticable. *Id.* at § 50.07[4][a]. If partitioning in kind produces minor inequalities in owners' shares, the court may award monetary payments (owelty) to offset the differences. *Id.* at § 50.07[4][c]. If a sale of the property and division of the proceeds is more equitable, and a fair division is not possible, all jurisdictions permit partition by sale and division of the proceeds. *Id.* at § 50.07[4][c] n.61-63.

Every partition action includes a final accounting for both charges and credits upon each co-tenant's interest. *Id.* at § 50.07[6]. Charges include received rents and profits beyond the co-tenants fractional share, fair rental value of the entire tenancy in common if the co-tenant has excluded the others, and waste committed by the co-tenant. *Id.* at § 50.07[6] n.74-75. Credits include expenditures in excess of the co-tenants fractional share for necessary repairs, improvements that enhance the value of the property, taxes, payments of principal and interest on mortgages and other liens, insurance for the common benefit, and amounts expended in protecting and preserving title. *Id.* at § 50.07[6] n.76.

D. Partition Law and Pre-RUPA Partnership Law Generally

At common law, a partnership was not regarded as a legal entity capable of holding title to real property and, as a result, such legal title was always in one or more of the partners. W.E. Shipley, *When Real Estate Owned by Partner Before Formation of Partnership Will be Deemed to Have Become Asset of Firm*, 45 A.L.R. 2d 1009 (1956). As a consequence, many cases arose before and after the enactment of the 1914 Uniform Partnership Act in determining whether realty and personalty held in joint tenancy and/or individual partners names were, in fact, partnership property. *See generally* W.E. Shipley, *When Real Estate Owned by Partner Before Formation of Partnership Will be Deemed to Have Become Asset of Firm*, 45 A.L.R. 2d 1009 (1956). The overarching consideration appeared to be a question of fact regarding the parties' intent. Shipley, *supra* note 14.

E. When is Joint Property Partnership Property under RUPA?

1. Is There a Partnership?

Under RUPA, a partnership is an entity distinct from its partners. RUPA § 201. This entity theory is intended to allay previous concerns stemming from the aggregate theory, such as the necessity of a deed to convey title from the "old" partnership to the "new" partnership every time there is a change of cast among the partners.

The general rule of partnership formation is that the association of two or more persons to carry on as co-owners of a business for profit forms a partnership, whether or not persons intend to form a partnership. *See generally* RUPA § 202. In determining whether a partnership is formed, joint tenancy, tenancy in common, tenancy by the entireties, joint property, common property, or part ownership do not by themselves establish a partnership, even if the co-owners

share profits made by the use of the property. RUPA § 202(c)(1).² As stated in the Comments to RUPA, the sharing of profits is recast as a rebuttable presumption of a partnership. RUPA § 202 comments at ¶ 3.³ Because the Ned and Roger Gibbs filed partnership tax returns, it can be assumed they intended a partnership under RUPA 202.

2. If a Partnership Exists, is the Tenancy in Common Real Estate Interest Partnership Property?

Under Section 203 of RUPA, property “acquired by a partnership is property of the partnership and not of the partners individually.” Section 204 of RUPA determines when property is partnership property and subsection (a) provides that property is partnership property if acquired in the name of (1) the partnership; or (2) one or more partners with an indication in the instrument transferring title to the property of the person’s capacity as a partner or of the existence of a partnership but without an indication of the name of the partnership (emphasis supplied). RUPA Section 204(b) elaborates when property is acquired in the name of the partnership, i.e., by a transfer to (1) the partnership in its name; or (2) by a transfer to one or more partners in their capacity as partners in the partnership, if the name of the partnership is indicated in the instrument transferring title to the property. Under 204 (c), property is presumed to be partnership property if purchased with partnership assets, even if not acquired in the name of the partnership or of one or more partners with an indication in the instrument transferring title

² See also Rev. Proc. 2002-22, containing federal tax law factors the IRS uses in issuing letter rulings on whether fractional interests rental property consists of an interest in a business entity, i.e., a partnership, thereby removing it from IRC 1031 tax deferral.

³ Of course, for federal partnership tax purposes, the partners may make an election not to be treated as a partnership if the partnership is for investment purposes only and not for the active conduct of business or for the joint production, extraction, or use of property and not for the purposes of selling services or property produced or extracted. IRC 761(a). (The IRS does not allow entities formed under a state’s partnership or limited partnership act to elect out of Subchapter K. The partners must have the right to take their share of partnership property at will under the state law and in the partnership agreement itself. FSA 199923017. The election may only apply to oil and gas interests. TAX FREE EXCHANGES UNDER 1031, Long, Foster, 2002 West Publishing Group, Section 9.90, p. 32). The partnership must not actively conduct business. Treas. Reg. §1.761-2(a)(1); see also TAX FREE EXCHANGES UNDER 1031, Long, Foster 2002 West Publishing Group, Section 9.09, p. 30.

to the property of the person's capacity as a partner or of the existence of a partnership (emphasis supplied). All 20,000 acres of the Gibbs' real estate is partnership property if it was purchased with partnership funds; otherwise, only the property titled in the name of the partnership or indicating the existence of the partnership, is partnership property.

F. Dissociation and Buyout or Dissolution: Analysis of RUPA Section 601, 701 and 801

Assuming that the real estate Ned and Roger owned is partnership property, David can only split up the real estate if dissolution, rather than a buyout of Ned's interest, is allowable under RUPA. Importantly, RUPA Section 601(7)(i) defines Ned's death as an event of dissociation not an event causing dissolution, *per se*. The distinction between dissociation and dissolution goes to the heart of the "entity theory" of a partnership because the entity is preserved and partnership interest is bought out. As stated in Comment 1 to RUPA Section 601, "the entity theory of partnership provides a conceptual basis for continuing the firm itself despite a partner's withdrawal from the firm."

RUPA 801(2) defines events causing dissolution and wind up and provides that the partnership is dissolved, and its business wound up, only if within 90 days after Ned's death, "at least half⁴ of the remaining partners express their will to wind up the partnership business." Accordingly, unless one of Roger or Larry desires to wind up the partnership, the partnership continues; the decision to split up the underlying real estate is accordingly out of David's hands.

Under RUPA 701(a), if Ned is dissociated from the partnership without a dissolution (by election of the remaining partners), the partnership, "shall cause the dissociated partner's interest

⁴ Prior to August 1997, Section 801(2)(i) provided that upon the dissociation of a partner in a term partnership by death or otherwise under Section 601(6) through (10) or wrongful dissociation under 602(b) the partnership would dissolve unless "a majority in interest of the remaining partners (including partners who have rightfully dissociated pursuant to Section 602(b)(2)(i)) agree to continue the partnership." This language was thought to be necessary for a term partnership to lack continuity of life under the Internal Revenue Act tax classification regulations. These regulations were repealed effective January 1, 1997. The current language, approved at the 1997 annual meeting of

in the partnership to be purchased for a buyout price determined pursuant to [RUPA 701(b)].”

The buyout is mandatory:

The buyout price of a dissociated partner’s interest is the amount that would have been distributable to the dissociating partner under Section 807(b) if, on the date of dissociation, the assets of the partnership were sold at a price equal to the greater of the liquidation value or the value based on a sale of the entire business as a going concern without the dissociated partner and the partnership were wound up as of that date. Interest must be paid from the date of dissociation to the date of payment.

As stated in Comment 2 to RUPA 701, “a payment to a partner for his interest can be characterized either as a purchase of the partner’s interest or as a liquidating distribution.” The “buyout price” is the greater of liquidation value or going concern value; liquidation is not intended to connote “distress sale value.” Comment 2 states, “the notion of a minority discount in determining the buyout price is negated by valuing the business as a going concern.” Interest must be paid from Ned’s date of death to the date of payment.

RUPA 701(e) provides for the purchase of Ned’s interest if no agreement is reached within 120 days “after written demand for payment.” The partnership shall pay, or cause to be paid, in cash to the dissociated partner the amount the partnership estimates to be the buyout price and accrued interest, reduced by permissible offset. The payment must be accompanied by (1) a statement of partnership assets and liabilities as of the date of dissociation, (2) the latest available partnership balance sheet and income statements, if any, (3) an explanation of how the estimated amount of payment was calculated and (4) written notice that the payment is in full satisfaction of the obligation to purchase, unless, within 120 days after written notice, the dissociated partner commences an action to determine buyout price. RUPA 701(g). A court may assess reasonable attorney’s fees and the fees and expenses of appraisers or other experts

the National Conference of Commissioners on Uniform State Laws, allows greater continuity in a term partnership than the prior version of this subsection and UPA Section 38(2)(b).

“against a party that the court finds acted arbitrarily, vexatiously, or not in good faith.” RUPA Section 701(i). The finding may be made on the basis of the partnership’s failure to tender payment or an offer to pay or comply with the financial disclosure requirements of RUPA 701(g).

1. Valuation of Tenancy in Common/RUPA property.

Roger and Larry have declined David’s demand to wind up and dissolve the property and have offered to purchase the partnership interest based on its underlying real estate value. David is now compiling Ned’s estate tax return and has instructed the appraiser to use discounts for tenancy in common real estate. An accountant friend assures David that “cost of partition” discounts are available on the basis of T.A.M. 199943003 and *Barge Estate v. Comm’r T.C.*; Memo 1997-188. The accountant assures David that additional discounts for minority discounts and lack of marketability may apply, citing *Sheperd v. Comm’r* 115 T.C. 376, Aff’d 283 F.3rd, 1258 (11th Cir. 2002).⁵

David’s tax attorney, however, has reviewed the RUPA buyout offer of Larry and David and believes no cost of partition, minority interest, or lack of marketability discounts apply; the

⁵ In recent years, it appears that the tax court has given credence to consideration of a lack of complete control in disposing of the property due minority discounts in addition to the cost of partition discounts. Specifically, the tax court has rejected the IRS’s argument that the cost of partition alone is the valuation rule. *See Sheperd v. Comm’r*, 115 T.C. 376, aff’d 283 f.3d 1258 (11th Cir. 2002). In addition, the tax court has allowed a 20% minority discount and an additional 10% discount for lack of marketability notwithstanding the fact that all owners were members of the same family in *Lefrak v. Comm’r*, T.C. Memo. 1993-526. *See also Williams v. Comm’r*, T.C. Memo, 1998-59 where the Tax Court allowed 44% discount for lack of marketability and lack of control and a fractional interest in real estate.

The tax court also affirmatively rejected the IRS’s argument that no discounts should be attributable to family owned property on the basis that it can be assumed the co-owners will participate to voluntarily dissolve or partition the property. *See Busch Est. v. Comm’r*, T.C. Memo, 2000-3; *see also Propstra v. United States*, 680 F.2d 1248 (9th Cir. 1982); *see generally*, VALUATION OF PARTIAL INTERESTS IN REAL ESTATE at 62-73 (A.S.A. Valuation, Dec. 1983). Contrarily, the tax court will not allow significant discounts for property held in joint ownership with right of survivorship valued under IRC § 2040(a). *See Young Est. v. Comm’r*, 110 T.C. Memo. 297 (1998). Still unresolved is the issue of whether a fractional interest discount is allowable in the instance of the death of a spouse who owns property as tenants by the entirety or other jointly owned property as joint tenants with right of survivorship. L. Paul Hood, *Valuation: General and Real Estate*, 830-2nd T.M.

tax lawyer, advises David that if the partnership is to continue without liquidation, the “going concern” requirement under 701, may preclude any discount.⁶

I. Conclusion and Practical Comments

Assuming all of the property was acquired with partnership funds or titled in the partnership, David’s father Ned’s death is an event of dissociation which triggers dissolution only at the election of Uncle Roger who comprises one-half of the remaining partners. If Roger does elect to continue the partnership and bring his son Larry in as a new partner, Roger may elect a RUPA Section 701 buy-out of Ned’s partnership interest. Ned’s estate will value the partnership interest with little if any discounts depending upon the valuation used under RUPA Section 701. In any event, the discounts available to Ned’s estate will likely be no greater than under partnership law generally because of the mandatory buy-out and the nature of the underlying assets as tenancy in common real estate. David will have no ability to compel a distribution in kind or partition of the real property and is likely subject to a forced buy-out.

The problem faced by David could have been resolved by a tenancy in common agreement between Ned and Roger, establishing, among other things, the postmortem rights of either party to partition various tracts of property. The real estate could nevertheless have been rented to the partnership, or preferably a limited liability company, and the revenues from the operation could have been partnership income to Ned and Roger. The benefit of this arrangement could have preserved the tenancy in common nature of the property, for flexibility of planning for tax deferral under IRC 1031, because Ned’s estate will receive a step up in basis

⁶ In the main, in the event of dissolution, general partnership interests may be valued with much smaller discounts (or no discount for lack of control and only a limited discount for lack of marketability). See *Adams v. United States*, 218 F.3d 383 (5th Cir. 2000); see also, *Est. of McCormack v. Comm’r, T.C.* Memo. 1995-371 (1995); HOWARD M ZARITSKY, TAX PLANNING FOR FAMILY WEALTH TRANSFERS: ANALYSIS WITH FORMS ¶ 10.04 (4th ed. 2002). If the underlying assets are incapable of being liquidated or only with substantial effort and costs, then the discounts may range beyond those attributable to costs of liquidation. See *Adams v. United States*, 218 F.3d 383 (5th Cir. 2000).

which David could have used for replacement real estate, which is not available for a partnership liquidation or redemption.