

Losing a Partner Without Losing Your Tax Shield

By James Brennan, JD/LLM & Aaron M. Gregory, JD/MBA

Real estate investors face a multitude of legal options when making investment decisions. Often, investors focus on a deal's economics rather than wrestle with legal issues. However, smart legal planning can maximize returns by ensuring favorable tax treatment and should be part of any investment decision.

The Section 1031 "like-kind" exchange is a legal tool that allows investors to upgrade their real estate holdings while deferring taxation. Theoretically, investors may exchange properties indefinitely without incurring tax. However, eventually some investors will want to "cash out" of their investment. Unfortunately, the exiting partner often exposes the entire partnership to substantial tax liabilities. This article identifies techniques available to partnerships that wish to redeem a member but preserve the 1031 tax shield.

When a real estate partnership dissolves, capital gains taxes may become due. If the partnership's property is sold and the proceeds distributed, the investors are subject to substantial taxation on any gains. Simple strategies, such as "buying out" the exiting member or specially allocating the gain, also subject the partners to taxation. Fortunately, several options are available to a partnership facing dissolution. These include the "drop and swap", the "swap and drop", the "split-off", and the installment note. With appropriate planning a transaction can be structured that meets the needs of both the exiting and remaining partners.

In the "drop and swap" the partnership makes a tax-free distribution of the investment property's title to the individual investors. Once the individuals possess title, each investor may "cash out" or make a like-kind exchange. The key to executing this strategy is ensuring compliance with Section 1031's "held for investment" requirement, making this strategy most appropriate for anticipated dissolutions.

If investors do not recognize the tax issue until just before the property is disposed, a "swap and drop" may be effective. This strategy resembles the "drop and swap" but is ordered differently. Here the partnership executes a like-kind exchange, waits to avoid IRS treatment as a "step transaction", and then drops title to the individual partners or refinances the new property to acquire cash to redeem the leaving partner.

Alternatively, a "split-off" strategy may be effective. In a split-off, the partnership distributes tenancy in common title to the exiting partner only, then the partnership makes an exchange in its name. Since the partnership keeps title in its name, the split-off provides title continuity, satisfying the "held for investment" requirement and allowing the leaving partner to cash out or exchange their interest.

Finally, the investors may sell the original property for cash and an installment note. In this approach the partnership distributes the exiting partner an installment note equal to his interest

while the remaining investors receive cash. The remaining partners use the cash to exchange into a new property and the exiting partner only recognizes gain as note payments are received.

The like-kind exchange provides real estate investors with a valuable wealth-building tool. But if the partnership dissolves, serious tax issues arise. Fortunately, with proper planning these risks can be minimized and transactions can be structured that maximize returns for all the partners.

James Brennan, JD/LLM is a Vice President of Wachovia Bank's Private Banking Division. He can be reached at James.Brennan@wachovia.com or at (703) 801-4178.