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Ending a real estate partnership: 1031 exchanges can play a role - by Michael Barone

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Michael Barone, Jr.,
Ruberto, Israel & Weiner

As the old song goes, “breaking up is hard to do.” And it certainly isn’t any easier when the person you’re breaking up with is your long-time real estate partner.

Imagine this: you and your business partner (or partners) are members of a limited liability company, or partners in a partnership, that owns a single developed property worth millions of dollars. You’ve both decided to call it quits, but you both want to continue investing in real estate (just not with each other). One of you could always buy out the other, but that requires cash on hand (maybe with a side of debt) and will certainly result in income tax liability for someone. Selling the property would be great – it gets rid of the business partner(s) and the property, giving you a clean break, but you’ve likely held the property for a while and your basis is low, so those capital gains taxes are bound to be ridiculous! You and your partner(s) clearly don’t want to own more property together, so a 1031 like-kind exchange seems to be off the table – but is it really?

Fortunately, all hope is not lost. If all parties can stomach each other a little while longer (i.e., a couple of years), there are ways for business partners to sell their existing property and keep the tax collector at bay, at least for now.

As a refresher, a 1031 like-kind exchange is a process outlined in Internal Revenue Code (IRC) Section 1031 that incentivizes owners of real property to reinvest sales proceeds from investment or business property (the relinquished property) in a like-kind property (the replacement property) while enjoying the benefit of deferring the taxable gains realized from the sale of the replacement property.

Generally speaking, in a standard (i.e., forward) exchange, the exchanger sells the relinquished property, deposits the sale proceeds with a qualified intermediary (the entity provided for in the IRC that facilitates a 1031 exchange), identifies a suitable like-kind property (the replacement property) within 45 days of the closing date for the relinquished property, and purchases the replacement property within 180 days of the closing date for the relinquished property.

As the name implies, the interests sold and purchased in a 1031 exchange transaction must be like-kind property interests and the deferral of gains only occurs when the property interests being exchanged are interests in investment or business properties (which may or may not be real property). Fortunately for exchangers, the term like-kind is pretty broad. For example, if you sell a multi-family apartment building, your replacement property need not be a multi-family apartment building – it could be an office building, a retail shop, a fast food restaurant, or even a strip mall. Other interests in real property (e.g., timber rights, mineral rights, development rights) can also be exchanged, however, the IRC is clear that partnership and certain business interests do not qualify as like-kind property interest. For the purposes of this article, we are solely discussing real estate.

The foregoing notwithstanding, with the appropriate planning, there is a way for business partners to go their separate ways, each end up with a replacement property of their liking (or some cash), and never have to deal with one another again: a “drop and swap” exchange. It should be noted that conducting a “drop and swap” exchange does take some time, so a degree of patience is required. Structuring an exchange this way requires the company to first execute “drop-down-deeds,” which are deeds transferring title out of the company or partnership and down to the individual members/partners as tenants-in-common with an undivided fractional interest. Unfortunately, before conducting the actual 1031 exchange, the tenants-in-common will need to continue holding the property as tenants-in-common for a certain period of time in order to satisfy the holding requirement under IRC Section 1031, which requires that the property has been “held for productive use in a trade or business or for investment.” Based upon IRS advisory memoranda and other documents, conservative practitioners generally consider this period to be two years, however, the determination is very fact specific and can be much shorter. Generally speaking, the IRS views the use of drop-down-deeds as evidence that the property is being held for sale, which will disqualify the property from exchange eligibility, so holding the property as tenants-in-common for a longer period of time helps to evidence investment intent.

Assuming all appropriate processes have been implemented properly and the appropriate holding period has elapsed, each of the business partners may sell its individual tenant-in-common interest (likely to the same purchaser) as a relinquished property and either conduct its own independent 1031 exchanges or pay its respective capital gains and pocket the money.

Of course, as with any tax planning, the company or partnership should always consult with its accountant and tax attorney ahead of time to confirm how best to limit tax exposure and satisfy the needs of each business partner.

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Michael Barone, Jr., is an attorney in the commercial real estate group at Ruberto, Israel & Weiner, Boston.