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Disposing of Real Property in a Tax-Advantaged Manner

Many of our clients are heavily invested in real property. In some cases, this investment may be a single property in a prime location; in others, the client (and maybe his family) is in the business of owning and operating a portfolio of properties of differing qualities and values. It is often the case that the real property constitutes the greater part of the client's wealth.

As the client gets older, he may seek to withdraw from, or to reduce his involvement in, the management of the real property. He may seek to diversify his portfolio, or to acquire one or more other properties to provide greater investment stability or to ensure a steadier stream of revenue in retirement.

He may seek to "re-task" his property to take advantage of changing circumstances in the neighborhood in which it is located, perhaps as part of a joint venture with a third party developer and property manager (this is happening in many parts of Queens and Brooklyn).

It many cases, the client may be able to leverage his existing real property and withdraw some of the equity therefrom in order to finance the acquisition of one or more new properties. In other cases, however, the client would prefer not to leverage the existing property and, so, has to sell that property, and then use the net proceeds therefrom to purchase other property.

Taxable Sale

A sale of investment real property is usually not desirable where it will generate a not insignificant tax bill. After all, the improvements on the property may have been held for many years, and have been almost fully depreciated, thus resulting in a very low adjusted basis for the property against which the gain on the sale of the property will be determined. Although most of the gain realized on the sale will likely be taxed as capital gain (a 20 percent federal tax rate) and as "unrecaptured depreciation" (a 25 percent federal rate), there may also be some ordinary income (a 39.6 percent federal rate, at least for now) if the client has depreciated various components of the property on an accelerated basis.1

For that reason, when a client wants or has to dispose of a real property, he would prefer to do so on a tax-free or, more accurately, tax-deferred basis.

Like Kind Exchange

The Code provides an exception from the general rule requiring the recognition of gain upon the sale or exchange of property. Specifically, no gain will be recognized if real property held by the taxpayer for productive use in a trade or business or for investment is exchanged solely for property of a like kind to be held by the taxpayer for productive use in a trade or business or for investment.2

In most cases, a taxpayer disposing of real property will not be able to swap his property with another taxpayer (a "simultaneous exchange"); for example, Taxpayer A transfers Property A to Taxpayer B in exchange for Taxpayer's Property B. In recognition of this reality, Congress and the IRS have provided special rules for non-simultaneous exchanges. Unfortunately, because of very strict statutory requirements, these rules are often not as helpful as most taxpayers would like.

A non-simultaneous exchange, where the relinquished property is transferred before the replacement property is acquired, generally may qualify for non-recognition of gain if the taxpayer identifies the replacement property or properties within 45 days of the transfer of the relinquished property, and then receives such replacement property within 180 days of the transfer. The taxpayer may only purchase one or more of the identified properties in order to complete a like kind exchange; an "unidentified" property does not qualify.3

In addition, as a general rule, the taxpayer may only identify up to three replacement properties. Under an alternative rule, however, the taxpayer may identify any number of like kind replacement properties, provided their aggregate fair market value does not exceed two times the fair market value of the relinquished property.4

Because the identification and acquisition periods cannot be extended, a taxpayer may find it very difficult to complete a like kind exchange. After all, 45 days is not a very long period of time within which to investigate, and identify, replacement properties. Even where replacement properties are timely identified, it may be difficult to acquire those properties within the prescribed 180-day replacement period. The taxpayer's diligence of the properties may uncover structural or environmental issues with the properties, or the owner may decide, for whatever reason, not to sell to the taxpayer.

In addition, because of the limits on the number of replacement properties that may be identified, and the time constraints for their acquisition, a taxpayer may find it difficult to diversify his real property holdings through a like kind exchange.

UPREIT

REITs, or real estate investment trusts, may be publicly traded corporations the assets of which consist of a diversified portfolio of real properties and related assets. They are comparable to mutual funds, and are required to pay out at least 90 percent of their income to their unitholders (shareholders).5

Unfortunately for a taxpayer who owns real property, he may not contribute his property to an existing REIT in exchange for an equity interest therein on a tax-free basis.6

That being said, many REITs are structured as UPREITs, or "umbrella partnership REITs." Under this structure, the REIT has formed a partnership that it controls. The partnership owns the REIT's real properties. An owner of real property who wants to dispose of such property on a tax-free basis may contribute his property to the UPREIT partnership in exchange for a partnership interest that is convertible into shares of stock (units) in the REIT partner.

In general, the owner's contribution of his real property to the partnership in exchange for a partnership interest is not a taxable transaction. A subsequent conversion of the partnership interest into REIT stock, on the other hand, would be a taxable exchange, though the taxpayer can plan for this tax consequence and may time it to his advantage.7

There are other potential tax consequences, however, that need to be considered. For example, if the real property being contributed to the UPREIT partnership is encumbered by debt, any reduction in the contributing taxpayer's share of that debt will be treated as a cash distribution to the taxpayer. If the amount of this reduction exceeds the taxpayer's basis in his partnership interest, he will recognize income to the extent of the excess.8 Similarly, if the debt was placed on the property within two years of the contribution to the partnership, the so-called "disguised sale rules" may cause the contribution to be treated as a partial sale of the property.9

In addition, the taxpayer will have to consider certain rules that are intended to ensure that the taxpayer will be taxed on the gain inherent in (or "built-into") his property at the time it is contributed to the partnership. Under these rules, if the partnership were to sell the contributed property, the gain realized would first be allocated, and taxed, to the taxpayer to the extent of the built-in gain.10 For that reason, the taxpayer will want to negotiate a period of time during which the partnership will not be permitted to sell the contributed property; otherwise, the taxpayer may never realize any tax deferral benefit. Alternatively, the taxpayer will want to be indemnified by the partnership for the resulting tax liability.

Joint Venture

The taxpayer may decide that his real property can be converted to a different, more profitable use. For example, commercial properties in good or up-and-coming locations may be turned into residential rental buildings or condominiums.

Because the taxpayer may not have the expertise or the financial wherewithal to do this on his own, he may decide to co-venture with a real estate professional to undertake the development project.

The joint venture would be structured as a partnership (usually in the form of an LLC) and, so, the contribution of the real property to the LLC will raise many of the issues described above regarding UPREITs. However, there may also be other factors at play. For example, although the owner will be contributing his real property to the venture in exchange for a membership interest therein, he may also want to take some equity off the table. In that case, the partnership (using funds contributed by the other partner) may distribute some cash to the taxpayer.

This cash distribution may cause the contribution of the property to be treated as a partial sale of the property. In that case, the taxpayer will have taxable gain, unless the distribution falls within one of several enumerated exceptions (including the reimbursement of certain pre-formation capital expenditures), or the taxpayer uses the proceeds to acquire replacement property as part of a like kind exchange. In general, the gain recognized will be treated as capital gain. However, such gain may be treated as ordinary income under the related party rules, depending upon the size of the taxpayer's interest in the partnership.11

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Wrap-Up

The foregoing was just a brief description of some of the ways in which a taxpayer may handle the disposition of his real property in a tax-advantaged manner. Of course, a taxpayer's particular facts may make it difficult to effectuate a disposition through one of more of these tax-deferral vehicles. For example, the taxpayer may not be the sole owner of the subject property. Once co-owners are introduced into the equation, it may be that all bets are off, depending upon their relationship and their relative priorities, and depending upon the terms of their partnership, operating, or shareholder agreement, if any.

Speaking of shareholders, if the real property is held in a corporation—every tax adviser's nightmare—the above deferral techniques will have to be employed at the corporate level, but the resulting economic consequences will also have to be considered from the perspective of the shareholders.

As always, it vwill behoove the real property owner to plan for his exit from the investment well in advance, and to structure his holdings in a way that will best facilitate such exit.

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1 IRC § 1(h).
2 IRC § 1031.
3 IRC § 1031(a)(3).
4 Treas. Reg. § 1.1031(k)-1(c)(4).
5 IRC § 857.
6 IRC § 351.
7 IRC § 1001.
8 IRC § 752.
9 IRC § 707; Treas. Reg. Sec. 1.707-3.
10 IRC § 704(c).
11 IRC § 707(b).