



Is it time to sell?

Part 3: Potential solutions to partnership differences

Partnership or spousal differences: Where business goals are not aligned, or personality conflicts arise, people are sometimes tempted to sell based on their desire to sever a relationship rather than for sound business reasons. Since partnerships are not easily split without selling the building and paying taxes, you may wish to consider alternative solutions.

1. Have an independent third party manage: The parties seldom have to talk to or see each other, and most likely would only need to communicate on larger decisions. The management company is given leeway for the smaller day-to-day operations, and is allowed to make all but the most important decisions.

2. Reconfigure your partnership agreement: Try to agree on an alternative structure, and engage an attorney to document your agreement. You may change ownership shares, or management responsibilities (some partners like to be “silent”, while others are natural managers). If both of you want to remain active, a different split of duties like bill paying, maintenance, etc. may resolve the tension.

3. Tax deferred exchange into management free property: While I have addressed this previously, there are a lot of nuances that require advance thought and which ideally should be covered in the original partnership agreement. First and foremost, is that since the decision to acquire property usually must be unanimous, one partner may be able to keep the exchange from happening thus imposing a large tax liability on the other partners. This problem can only be dealt with up-front, i.e. before the initial investment is made. Partners should also be clear on how replacement properties will be chosen and offers made. It is sometimes difficult for multiple partners to coordinate their schedule in order to comply with the exchange requirements such as the 45 day designation rule (replacement properties must be designated within 45 days of the closing of the relinquished property). Procedures allowing these tasks to be delegated should be worked out ahead of time.

4. Installment Sale (Seller carry financing): Provided the deal is correctly structured, taxes on capital gains and depreciation recapture may be postponed until receipt of payments on the note, but the additional aspects of possible foreclosure, prepayment, assumption, etc. must be agreed on and adequately considered between the partners.

5. Cash out and pay taxes: This option is somewhat self-explanatory, but a good accountant would still coach you on realizing the gain in a year where available losses will help offset gains, and where taxes will become due when you have the funds required to pay them. An additional note here is that escrow companies are now required to withhold a portion of the Seller's proceeds in a real estate transaction where the funds are not going to an exchange accommodator.

6. Separate the partnership without paying taxes:

Breaking up a partnership does not always involve paying deferred taxes. Many partnerships attempt to split up in the 1031 exchange process, which is not advisable unless they have previously converted to a tenants-in-common structure, or utilized one of the other options recommended by a partnership attorney. In very general terms, a tenants-in-common ownership entity may separate upon sale in a way which allows the separate parties to go their own way and purchase their own replacement properties. This must be done properly as there are various pitfalls that even many industry experts do not agree on. For example, a partnership that converts to a tenants in common structure just before sale takes a large risk that the IRS would invalidate the exchange. Recommended timeframes to wait after converting to a TIC structure range from one tax year to several tax years and may be affected by other circumstances. Another substantial risk is that an entity calling itself a TIC but still having a "partnership" agreement and operating as a partnership faces increased exposure to a potential audit. If done properly this and other strategies that exist are potentially great methods to completely dissolve a partnership without paying taxes on the capital gains and depreciation recapture.

In summation, there are seldom easy solutions to partnership differences, but if the proper professionals are consulted, there are workable options to consider, and various methods to minimize both stress and taxes.

Please keep in mind that my area of expertise is Real Estate Brokerage. The tax consequences, exchange validity, accounting rules and legality of various strategies are best discussed with the appropriate professional. I have several that I will be happy to recommend. If you missed last month's installment, you may contact me for a copy of the last issue.

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