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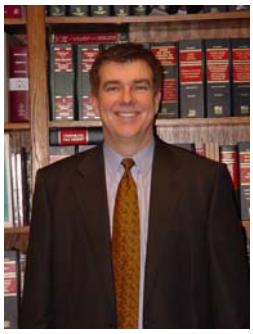

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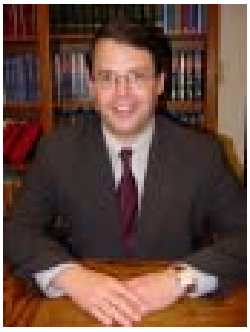

Richardson

Tax Advantaged Strategies for an Exiting Partner

A partnership (which includes a limited liability company) is the preferred entity in which to own real estate. In contrast to corporations, distributions of appreciated property from partnerships can, in many cases, be made without triggering tax on the appreciation.

Background

The unrestricted ability of partners to receive distributions of property tax-free allowed taxpayers to use partnerships to effect a sale of property without paying tax (by combining contributions of property to a partnership and distributions of cash from a partnership). Recognizing this potential for abuse, Congress has passed a series of anti-abuse rules which place restrictions on the ability of partners to receive tax-free distributions. However, in many circumstances, partners and partnerships continue to have great latitude to take advantage of tax-free distributions in planning for the exit of a partner.

Sale or Redemption

An exiting partner has several options. We will focus on two of them. First, a partner may sell his partnership interest to another partner or a third party and receive cash or property. Second, the partner may be redeemed from the partnership, by exchanging his partnership interest for cash or property from the partnership. From an economic standpoint, both a sale and a redemption may put the partner in the same position. However, the tax consequences can differ dramatically.

Tax Consequences

An exiting partner who sells his partnership interest to another partner or a third party will recognize taxable gain to the extent the value of the cash and property he receives exceeds his basis in his partnership interest. A sale of a partnership interest (even if the partnership owns only real estate) does not qualify for a tax-free like-kind exchange. Alternatively, an exiting partner who is redeemed from a partnership will generally not recognize gain to the extent he receives a distribution of property. A properly structured partnership exit strategy can, in many cases, provide a benefit as good as or better than a like-kind exchange without the restrictions of a like-kind exchange.

Conclusion

In our practice, we have unfortunately witnessed many situations in which a partnership and an exiting partner pick the wrong exit strategy from a tax standpoint. Very few tax advisors fully understand the truly remarkable tax planning options available to an exiting partner. The flexibility of a partnership places a premium on making the right choice when a partner exits a partnership. Proper planning, in advance of an exit, can avoid unnecessary tax on an exit for both the partnership and the partner.

The authors of this article, Bill Culp and Mark Richardson, are tax attorneys with the tax law firm of Culp Elliott & Carpenter, P.L.L.C., located in Charlotte, North Carolina. They spend a substantial amount of their time advising real estate owners and developers on structuring deals to achieve the desired business and tax results. They can be reached at the following e-mail address: mlr@ceclaw.com