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Building Wealth: Planning with Real Estate Prior to 2026

Learn why the freeze partnership strategy may be worth considering

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Key points

- Despite its variety and diversity as an asset class, certain traits are common across real estate that can require careful consideration when planning for those properties
- If you own negative capital real estate, it is important to plan carefully, as some strategies may not be viable and, in some cases, could jeopardize the success of your wealth plan
- The freeze partnership strategy could provide a number of tax and non-tax benefits based on your specific circumstances

Now that the dust has settled on the 2024 election and President-elect Trump and Congress will be sworn into office in January, among the many questions they will face is how to address the rapidly approaching expiration, or sunsetting, of certain provisions within the Tax Cuts and Jobs Act of 2017 (TCJA) at the end of 2025.

As a real estate owner, investor, or developer, one of the key provisions of the TCJA that could impact your wealth planning is the temporary increase to the lifetime exemption from gift and estate tax, which effectively acts as a cap on the amount of wealth, including real estate interests, that can be transferred during lifetime or at death. In 2025, the exemption will reach a historic high of $13.99 million, or $27.98 million for a married couple, but beginning in 2026, the exemption would be reduced to pre-TCJA levels, potentially to as low as $6.5 million per person ($13 million for a couple), a reduction by over half.

There are a number of strategies that you could use to take advantage of your exemption prior to 2026, but one in particular, could stand above others when it comes to planning for your real estate: the freeze partnership. Although receiving less attention than other common planning techniques, including certain types of irrevocable trusts, the freeze partnership can be particularly useful when planning with real estate, where other strategies may be less effective and possibly counterproductive.

This article will begin by discussing some of the tax and non-tax attributes unique to real estate, then explain how those could impact your planning, and finally discuss why the freeze partnership might be the right strategy around which to build your wealth plan.

Why is real estate different when it comes to planning?

Despite its variety and diversity as an asset class, certain traits are common across real estate that can require careful consideration when planning for those properties. These include:

High leverage. Leverage is often used as a tool when acquiring real estate, typically in the form of a mortgage, or as a means to extract liquidity from appreciated property, through a cash-out refinance. Regardless of the timing and reasoning, business or investment real estate is often encumbered by some amount of debt.

Low basis. Properties that were acquired long ago and that have appreciated over time are likely to have an income tax basis that is substantially lower than their current fair market value.[1] Even if a property was acquired more recently, allowable depreciation deductions may have eroded the tax base during the course of ownership.[2] Similarly, if a property was acquired via a like-kind exchange, it may have a low tax basis due to carrying over the basis from the relinquished property.[3] In today's real estate market, these are all common scenarios.

Entity ownership. Often, real estate owners hold their interests through entities taxed as partnerships, whether structured as a limited partnership or limited liability company (LLC). While these structures can provide owners with a number of benefits, both tax and non-tax, their treatment for tax purposes can be complicated and nuanced, potentially causing additional planning complexity.

When high leverage, low basis, and entity ownership are taken together, it can cause a somewhat unique planning scenario, known commonly as negative capital. Put simply, negative capital occurs when debt on a partnership's property is greater than its tax basis.[4]

If you own negative real estate, it is important to plan carefully, as some strategies may not be viable and, in some cases, could jeopardize the success of your wealth plan.

How might negative capital impact your planning?

As with any planning, there are generally three options to consider for your real estate interests—sell it, gift it, or hold it. If, however, you have negative capital real estate, these options may be limited by the tax attributes associated with those properties. Following is a breakdown of each option and what it could mean for you.

Selling negative capital

When debt on a property exceeds its basis, as in the case of negative capital real estate, you could incur phantom gain when selling that property.[5] This can result in the recognition of income taxes that consume a large portion of the net sale proceeds, or worse, taxes that exceed sale proceeds, resulting in taxes without sufficient liquidity to pay them. This often makes the prospect of selling negative capital real estate unattractive or altogether unrealistic.

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Gifting negative capital

If you or your family have a substantial real estate portfolio, you may be interested in gifting some or all of your properties to your children during your lifetime. While a gift generally is not a taxable event for income tax purposes, that is not the case if the debt exceeds basis.[6] If that is the case, your gift could result in gain recognition, meaning you might end up paying income tax on the gift.[7] This makes an outright gift of negative capital real estate unattractive as well.

As an alternative, you might consider gifting your property to a grantor trust, which generally is not a recognition event for income tax purposes.[8] Although grantor trusts, which include grantor retained annuity trusts (GRATs) and intentionally defective grantor trusts (IDGTs), can be effective wealth planning tools for this and other reasons, they may be less so with negative capital. While a transfer of negative capital to a GRAT or IDGT may not result in gain recognition at that time because you and the trust are considered the same taxpayer, it is uncertain whether gain would be recognized at some point in the future. When the trust ceases to be a grantor trust and becomes its own taxpayer, which could occur either during your lifetime or upon your death, there could be a taxable event at that time.[9] This also makes gifting negative capital real estate to a grantor trust potentially perilous.

Even if gain recognition can be deferred, using a grantor trust foregoes a critical tax planning opportunity. When property is transferred to an irrevocable trust, like a GRAT or IDGT, as a completed gift, the basis in that property carries over, meaning the trust would have your low basis in the property.[10] If the trust later sells the property, it could incur a substantial gain and the resulting income tax could consume most or all of the net sale proceeds.

Holding negative capital

To avoid saddling your heirs with a future income tax bill, you might consider holding your real estate until death in order to receive a so-called basis step-up.[11] As a general rule, the basis of any property you hold at death is stepped up to its fair market value at the time of your death.[12] This can effectively eliminate unrealized gain on appreciated property, including real property held inside an entity taxed as a partnership.[13] In cases of negative capital real estate, this basis adjustment can be crucial because it allows your heirs to receive property with a new basis equal to its fair market value at your passing. This would reduce the amount of gain, including phantom gain, that previously made a sale of the property undesirable and could allow your heirs to sell or plan with the property as they wish.

Although holding negative capital real estate until death might improve the income tax result for your family, it is not without tax risk because it might expose the property to an estate tax. As noted, an estate tax is imposed on estates exceeding the federal gift and estate tax exemption amount ($13.99 million per person in 2025), and a number of states also assess separate state level wealth transfer taxes. By holding real estate until your death, that property might be subject to one or both of these taxes, which could result in a combined tax rate of 50% or more. This makes holding real estate to obtain the basis step-up potentially costly for your family.
In some cases, the estate taxes imposed on the property, whether federal, state, or both, could far outweigh the income taxes saved from the basis step-up, jeopardizing the effectiveness of this strategy as well.

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Holding real estate until death can also create a potential liquidity issue, as estate taxes are generally due within nine months of death. Since real estate is a largely illiquid asset, meaning that it may not be easy to sell quickly, it's important that, if you do hold real estate until death, you have a plan in place to pay the potential estate tax liability. Life insurance, coupled with an irrevocable life insurance trust, could be an effective strategy to plan for the payment of future estate taxes, but that may be just one part of your comprehensive plan.

In light of the nuance and implications of planning with negative capital, you might consider an alternative approach: the freeze partnership.

What is a freeze partnership?

In its most basic form, a freeze partnership is an entity, whether structured as a partnership or an LLC, that has two economic interests: a preferred interest and a common interest. Each of these interests has different rights and attributes and are often structured as follows:

Preferred interest. The preferred interest typically is entitled to a defined annual payment from the partnership, known as a qualified payment right. This is determined by market appraisal but frequently ranges from 6-9% of the value of the preferred interest.

Common interest. The common interest receives any returns not allocated to the preferred interest along with any growth in the value of the underlying assets. Much of the liabilities also could remain with the preferred interest with proper structuring.

Given this division of the partnership's economics, the bulk of its current value typically is attributed to the preferred interest, with the common interest generally representing a smaller portion of the entity's overall value. In fact, it could be the case that up to 90% of the partnership's value is attributed to the preferred interest, with as little as 10% attributed to the common.

How do you create a freeze partnership?

You could establish a freeze partnership by creating a new entity, which could be a partnership or LLC, or by recapitalizing an existing entity into a preferred and common capital structure. Once the entity has been formed, you could then contribute interests in partnership-held real estate to that entity in exchange for the preferred and common interests. By closely adhering to certain partnership tax formalities, this contribution should not be a taxable event.[14]

After the initial contribution, you could retain the preferred interest and then gift or sell the common interest to your family or to a trust for their benefit. By completing a gift of the common interest prior to 2026, you could use some or all of your available lifetime exemption prior to the TCJA expiration, taking advantage of this potentially significant planning opportunity. Careful structuring would be required, however, to avoid the application of certain rules that could artificially inflate the value of your gift, potentially using more exemption than you planned or even causing an unintended gift tax.[15]

Having properly structured and implemented the partnership, as holder of the preferred interest, you would be entitled to annual distributions from the partnership in the form of qualified payments. Any income not paid to you would flow to the holder of the common interest along with the growth in the value of the partnership, namely appreciation of the underlying real estate.

What are some of the benefits of the freeze partnership?

The freeze partnership could provide a number of benefits, both tax and non-tax, to you and your family.

Estate tax mitigation. Implementing a freeze partnership structure could be an effective way to use some or all of your lifetime exemption before the exemption is scheduled to be reduced in 2026. Moreover, by utilizing a freeze partnership structure, you could reduce, or freeze, the value of the assets that would be includible in your taxable estate at death. While you could retain the preferred interest for lifetime, potentially exposing it to an estate tax, that should represent only a fraction of the freeze partnership's overall value. The bulk of the growth would be attributed to the common interest holder, which would be outside of your estate and so not subject to estate tax. This could allow a significant portion of the partnership's value to pass to the next generation without incurring an estate tax.

Basis step-up. Any property you hold at death would be stepped-up to its fair market value at that time. By retaining the preferred interest for life, you could effectively eliminate some of the negative capital attributes, including the phantom gain, which could result in less income tax on a future sale of the partnership property.[16] If your heirs decided to hold rather than sell the underlying real estate, it would also mean they would have a partially refreshed basis from which to depreciate the property, which could provide them with further tax benefits.

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Cash flow. As the holder of the preferred interest, you would be entitled to receive annual distributions from the partnership in the form of qualified payments.[17] This makes it a particularly compelling strategy if you are looking to leverage your lifetime exemption while maintaining cash security.

Management succession. If you are looking to remain involved in the management and day-to-day operations of the property, a freeze partnership could also allow you to do so, where other gifting strategies may limit your involvement or potentially risk adverse tax consequences. At the right time, however, the freeze partnership could serve as an effective vehicle to help transition your ownership and control to the next generation.

What else should you consider in creating a freeze partnership?

As with other planning strategies, the freeze partnership may not be appropriate for every real estate owner in all circumstances. In weighing the freeze partnership against other planning opportunities, you might keep in mind some of the following:

Property cash flows. For the freeze partnership to perform as intended, the underlying properties should have sufficient cash flow to support the qualified payment right due to the preferred interest holder. Insufficient cash flow from the real estate could risk the potential estate and tax planning benefits of the structure and the strategy as a whole.

Individual cash flow needs. It is important to analyze and consider your cash needs relative to the qualified payments due as the preferred interest holder. If those payments are in excess of your needs, this strategy may be less successful as a freeze technique, as the surplus cash could increase your taxable estate. For this reason, the freeze partnership is sometimes known as a leaky freeze, as it could leak value back into your estate.

Structural complexity. Given the strategy's highly technical and complex nature, its overall success may hinge on your ongoing commitment to the structure and the skillset of your multidisciplinary advisory team.

The TCJA has created a potentially historic opportunity to transfer wealth tax efficiently, but the window of time to act is rapidly closing, with certain provisions of that legislation set to sunset at the end of 2025. Given that, now is the time to take action, and the freeze partnership might just be the right foundation upon which to build your plan.

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As part of the Wilmington Trust Emerald Family Office & Advisory® team, Matt is responsible for developing customized wealth management strategies and financial plans for high-net-worth individuals, families, and business owners in the Tri-State area that includes New York City, Westchester, Long Island, Connecticut, and northern New Jersey. Matt works closely with clients and their advisors to develop financial and tax planning strategies to help clients meet their current needs and plan for their long-term objectives.

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APPENDIX

ENDNOTES

1. Generally, tax basis is equal to the acquisition cost of a property, adjusted to reflect various expenses and improvements along with certain deductions taken over time, including for depreciation; see I.R.C. §§ 1012, 1016.
2. .R.C. § 167.
3. See I.R.C. § 1031.
4. See Reg. § 1.755-1.
5. See Reg. § 1.731-1
6. See I.R.C. § 102(a).
7. See I.R.C. § 1015.
8. See generally, I.R.C. §§ 671-679.
9. See Reg. §1.1001-2(a)(4)(v). See also §752(d).
10. See I.R.C. § 1015.
11. See I.R.C. § 1014.
12. See Id.
13. See I.R.C. § 754.
14. See I.R.C. § 721.
15. See I.R.C. §§ 2701, 2702.
16. See I.R.C. §§ 754, 1014.
17. See I.R.C. § 2701.

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