

Can entity owners pursue 1031 exchanges apart from their co-owners?

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When multiple parties collectively own and seek to sell investment property, the parties' individual business goals often diverge. One party may seek to cash out, while another may want to re-invest the sales proceeds in a similar investment property to defer capital gains tax on sale through a like-kind exchange under Internal Revenue Code Section 1031.

Unfortunately, tax deferred treatment of capital gain under Section 1031 is allowable only to the taxpayer who directly owns the investment property. If a business entity such as a partnership, limited liability company, or trust sells the investment property, then only that business entity may claim the tax deferred treatment upon buying the replacement property, and the beneficial owners of the title-holding entity may not separately claim benefits under Section 1031. With foresight and careful planning, however, it may be possible to unravel the entity structure to allow each party to follow its own path.

One ownership vehicle, the tenancy-in-common structure, gives each tenant-in-common, or co-owner, flexibility to decide how to reinvest its share of the sales proceeds, allowing the co-owners to take separate paths upon sale of the property. Those co-owners that wish to enter into a 1031 like-kind exchange may do so. Others that want to cash out can pay their share of the taxes and walk away from their co-owners. Business entities (such as partnerships, limited liability companies and trusts) must convert to a tenancy-in-common structure to allow each beneficial owner to pursue its own course following the sale.

Before setting up the tenancy-in-common, the business entity must be dissolved and the investment property distributed to each beneficial owner, subject to notice or consent requirements, if any, imposed by the business entity's lender under applicable loan or security agreements. In most cases, the dissolution of the entity and distribution of assets will be a non-taxable event. (This article does not discuss the potential restructure of a corporate entity since its dissolution may lead to adverse tax consequences.) The parties may create single-member limited liability companies to hold each owner's respective interests in the distributed investment property as tenants in common or co-owners. The use of limited liability companies are advantageous because they are disregarded for tax purposes and provide liability protection.

The next step is to carefully structure the tenancy-in-common to protect the rights of the former beneficial owners, but without re-creating the business partnership that previously existed. The tenancy-in-common structure must satisfy the indicia of co-ownership, as documented in a tenancy in common agreement, consistent with the requirements of Revenue Procedure 2002-22. Such agreement must define each co-owner's percentage interest in the property, appoint a property manager, provide for first refusal rights for co-tenants to buy-out each other's interests, and provide for the sharing or distribution of profits proportionate to each co-owner's interest in the property.

Revenue Procedure 2002-22 provides some limitations, such as the number of owners and the need for unanimous consent by co-owners for lending and rental activities. The tenant in common structure does not file a tax return. Rather, each co-owner must report its income or loss on its own tax return. The tenancy-in-common must be structured to assure compliance with the Revenue Procedure in order to be assured that each co-owner is eligible to receive tax deferred treatment under Section 1031. Once the tenancy in common structure is in place, the co-owners have laid the groundwork for an eventual sale of the property, with the desired flexibility for each individual owner as tenant in common to undertake a Section 1031 like-kind exchange.

It is imperative for the taxpayer to form the tenancy in common and to distribute the investment property into each co-owner, well in advance of a sale. It is unlikely that the IRS will recognize the tenancy in common as a valid structure for Section 1031 purposes if the business entity is dissolved immediately prior to the sale of the relinquished property. The taxpayer will need to consult with its legal and tax advisors for guidance on setting up the new ownership structure to comply with the Internal Revenue Code and associated regulations.

In conclusion, dissolving the entity structure and replacing it with a tenancy-in-common gives the multiple beneficial owners flexibility to maintain common ownership of their investment property, while allowing each beneficial owner the ability to achieve their separate business goals upon sale of the property.

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