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# Advanced planning is necessary to achieve all the benefits a 1031 exchange makes available

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Many real estate owners discover too late that they are unable to complete a valid 1031 exchange due to how they own the property they will sell. The most common problem arises when co-owners want to part ways following the sale of the property. The co-owners may want to buy separate replacement properties, or one of the co-owners may desire to effect a 1031 exchange while the other co-owner wants to cash out. If ownership of the property that will be sold is treated as a partnership, corporation, or trust for tax purposes, complications will arise.

The 1031 exchange rules allow any type of taxpayer to effect a 1031 exchange on its own behalf. These various types of taxpayers include individuals, partnerships, LLCs, corporations, and trusts. However, one of the basic rules of 1031 exchanges will create problems when co-owners, such as partners, shareholders, or beneficiaries, desire to acquire replacement property outside of the entity. This basic rule requires that the taxpayer who sells the relinquished property must be the same taxpayer that acquires the replacement property. If a partnership sells a property, then in order to effectuate a valid 1031 exchange, the partnership must be the buyer of the replacement property. If the individual partners buy the replacement property, the exchange fails. In addition, section 1031 specifically precludes partnership interests, corporate stock, and interests in trusts from qualifying for 1031 exchanges.

In order to avoid this problem, partners of a partnership, including members of an LLC taxed as a partnership, are tempted to distribute the property to the partners as tenants-in-common prior to the sale. Except in rare circumstances, this technique typical fails to satisfy the IRS requirements. Four hurdles must be overcome (i) the co-ownership must not constitute a new or continuing partnership for tax purposes, (ii) the property must be held by the co-owners for productive use in a trade or business or for investment, (iii) the assignment of income doctrine must not be violated, and (iv) the step transaction doctrine must not apply. A full discussion of these four hurdles is beyond the scope of this article. The following information focuses on the first of the four hurdles listed above.

Many factors are taken into consideration in determining whether a co-ownership (tenants-in-common) will be recognized as a partnership for tax purposes. These factors are based on local law, but are looked at in conjunction with the tax laws. One of these factors is whether the co-owners ever owned the property as partners. If so, then the IRS may assert that either a new partnership was formed under the same terms, or a new partnership was created. If so, and if the co-owners then sell their tenants-in-common interest, they will be deemed to have sold a partnership interest, which is precluded from qualification under section 1031. Or, at the very least, the taxpayer that purchases the replacement property will be different from the taxpayer that sold the property, thereby invalidating the exchange.

This rule takes on an even more fatal flaw when a corporation is involved. A distribution of an appreciated property from a corporation to its shareholders results in immediate gain recognition at the corporate level. Thus, as a practical matter, a 1031 exchange is useless since no gain will be deferred.

Taxpayers who plan ahead are able to structure the co-ownership of their real estate in ways that will allow for a future 1031 exchange, while also providing adequate protection from liabilities and allowing for efficient management of the properties. One form of proactive ownership involves each of the co-owners forming their own single-member LLC to own a true tenant-in-common interest. If structured properly, the IRS will respect this form of ownership and not recast the co-ownership as a partnership for tax purposes.

The other common problem arises when the co-ownership is properly characterized as tenants-in-common, but for one reason or another, partnership tax returns have been filed. A taxpayer will have a difficult battle with the IRS in attempting to assert that the co-ownership is not a partnership when partnership tax returns have been filed consistently for many years. This problem is common when taxpayers utilize the Massachusetts realty trust.

The bottom line is that despite all of the complexities of the tax laws, taxpayers have a multitude of options available to meet all of their tax, operational, and creditor protection needs. However, advance planning is necessary to achieve all of these worthy goals.

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