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Equity financing agreements in a 1031 exchange - by Lynne Bagby

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Although this investment property financing structure is not new, throughout New England and across the country there is an increased interest by 1031 investors to participate in an equity financing agreement (as explained below) primarily because of the currently high real estate values and the inability of a different party to come up with all of the required down payment, or to acquire a mortgage on their own for a property they wish to purchase personally for themselves.

The purchase of an undivided interest in investment property with a third party, including a child or other family member, who will occupy the property as their principal residence (referred to as the "occupying-co-owner") can qualify as replacement property under IRC Section 1031, and the investor-co-owner can receive rental income and depreciation benefits, provided the arrangement meets certain criteria in a written "shared equity financing agreement." The shared equity financing agreement is defined in IRC Section 280A(d)(3)(C) and in IRS Publication 527.

These agreements are often used in situations where the co-owner in the stronger financial position contributes the down payment for the purchase of the house, and the other co-owner will occupy it as a primary residence. Shared equity financing arrangements are sometimes used to help a child purchase a home. These agreements may also be used when the occupying-co-owner does not have the down payment needed to purchase a home but has enough income to pay the monthly mortgage payment. Alternatively, a shared equity financing agreement can be used when a co-owner can afford to purchase a home but cannot qualify for a mortgage independently.

Under these agreements, the investor co-owner receives rental income based upon their ownership percentage. For example, if fair market rent for a property is $2,000 and the investor-co-owner owns a 40% interest in the property through a shared equity financing agreement, the occupying co-owner must pay the investor $800 a month in rent. This fair market rent should be paid for at least two years after the date of acquisition of the replacement property by the investor-co-owner in a 1031 exchange. After a predetermined period specified in the written agreement, the occupying-co-owner either buys out the investor-co-owner, or the house is sold and profit split pursuant to the written agreement.

In situations where an investor purchases replacement property in a 1031 exchange with an occupying-co-owner, the written agreement must define in detail the financial relationship between the two co-owners. Issues to be addressed in the written agreement include: the amount of fair market rent that will be paid to the investor-co-owner for use by the occupying-co-owner; and who bears the responsibility for repairs, maintenance, property taxes, hazard insurance, homeowner association dues, and other ownership costs. Typically, the non-loan-related expenses are divided between the co-owners in proportion with their ownership percentages. The loan payment costs (principal and interest on the loan) may be allocated under a different percentage depending on the terms of the shared equity financing agreement.

If there is no written agreement and/or the occupying-co-owner does not pay fair market rent, the IRS will classify the property as the investor-co-owner's second home. Accordingly, this property would not qualify as replacement property in that investor's 1031 exchange since a second home that is not a rental property – or that does not qualify under Revenue Procedure 2008-16 – does not meet the "held for investment" requirement in Section 1031.

A well-drafted shared equity financing agreement, along with a recordable memorandum of agreement, will provide the investor-co-owner with protections and the right to sell the property if the occupying co-owner does not pay agreed-upon costs. Investors should seek legal and tax advice from knowledgeable tax/legal advisors who can assist with the preparation of the necessary shared equity financing agreement and other documentation to achieve the investor's goals.

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