COMMERCIAL INVESTMENT Real Estate

Exchanges

Avoiding Exchange Pains

Cut Out Thorny Entity Issues in the Tax-Deferred Exchange Process.

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Today, most tax-deferred exchange transactions are relatively straightforward and easy to execute. But occasionally, an "entity issue" arises when someone exchanging a property wants or needs to take title to the replacement property in a different manner than the relinquished property was conveyed. Although Section 1031 of the Internal Revenue Code does not state explicitly that title must be received on the replacement property in the same way it was given on the relinquished property, it directly is implied. Subsequent case law has reinforced this understanding.

Thus, the following strategies address several potentially thorny entity issues that may arise in exchanges depending on different individual and group ownership situations and how to deal with them. These ownership scenarios include spouses, limited liability companies, trusts, corporations, and partnerships.

Individual Ownership Entity issues relating to individual property ownership in exchanges can stem from spousal, limited liability company, and trust ownership.

Exchanges Involving Spouses. Rebecca is selling a property and wants to do a 1031 exchange. She has hired a qualified intermediary or trust to facilitate the transaction and plans to use the direct deeding method. Under this method, she simply will deed her relinquished property to the buyer and receive a deed from the seller when she buys a replacement property.

But what if Rebecca and her husband each own a 50 percent undivided interest in the relinquished property? In that case, both would convey title at the sale of the relinquished property. What if only Rebecca wants to take title to the replacement property? Is there a negative tax impact to the couple?

The Internal Revenue Service offered an opinion on a similar situation in Private Letter Ruling 8429004. In this case, a husband and wife each held a 50 percent interest as tenants-in-common to a property that substantially had been destroyed and fell under the involuntary conversion rules (covered under Section 1033 and considered akin to those outlined under Section 1031). In the acquisition of the replacement property, the wife was not named on the deed. The IRS indicated that a full tax deferral was not possible and that 50 percent of the gain on the sale of the property would have to be recognized.

Consequently, to complete a successful exchange involving common ownership between spouses, it appears that title should be taken on the replacement property in the same way as it was conveyed on the relinquished property.

Outside the realm of tax-deferred exchanges, the IRS usually allows unlimited gifting of assets between spouses without triggering a taxable event. One solution to Rebecca’s problem would be to make appropriate changes to title prior to selling the relinquished property. This can be done by executing a deed that establishes the desired ownership prior to conveying the relinquished property.

Sometimes, to meet the financial requirements necessary to qualify for a loan on a replacement property, both spouses must be named as borrowers. Further, in order for the lender to maintain a proper security interest in the property, both spouses also must take title to the property. What can be done in this situation if a couple needs to purchase a replacement property jointly to satisfy a lender, but only one of them currently owns the relinquished property?

If the spouse owning the relinquished property executes and records a deed for a 50 percent undivided interest to the other spouse before selling the relinquished property, both can take title to the replacement property. In this way, both incomes can be used to meet the financial requirement for an acquisition loan.

Exchanges Involving LLCs. Another entity issue can arise when an individual who personally holds title to a relinquished property wants to do an exchange. The problem surfaces when the exchanger begins seeking the financing necessary to purchase a replacement property. It is becoming increasingly common for some lenders to require a borrower that is best described as a single-asset bankruptcy remote entity. In simpler terms, a lender only will approve funding to an entity that owns the property that is collateral for the loan as its sole asset. The lender, often a conduit source, seeks to maximize its position in the event of default. If foreclosure is necessary, the lender can regain the collateral more easily from this type of borrower rather than dealing with an individual or partnership that owns multiple assets and owes multiple creditors. The lender is less vulnerable to liberal bankruptcy laws when loaning to a single-asset entity. Such an entity requirement by the lender would force the exchanger to take title differently on the replacement property than it was given on the relinquished property. This could invalidate an exchange.

Recently, the acceptance by most states of single-member LLCs has provided a potential solution to the problem. A single-member LLC is recognized as a legal entity, can be transparent for tax- reporting purposes, and meets most conduit lenders' requirements. This new entity provides the option of flowing through tax consequences to an individual's personal return. (As a result, transactions with this type of entity generally are treated as transactions of the owner.) A single-owner noncorporate business entity is disregarded as a tax entity separate from the single owner for federal tax purposes (Treasury Regulations 301-7701-2[c][2]). The IRS has held that the acquisition of replacement property by a taxpayer's wholly owned, single-member LLC, which is a different legal entity, does not disqualify the taxpayer from completing a valid exchange (Private Letter Rulings 9807013 and 9751012).

Exchanges Involving Trusts. Many individuals have placed real estate into revocable living trusts or grantor trusts for estate-planning purposes. These trusts are not considered separate entities for tax-reporting purposes (IRC 671-678), but instead flow through tax consequences to the beneficiaries. Like a typical investor, a trust may sell a relinquished property and buy a replacement property to complete a tax-deferred exchange.

Common entity issues arise in two situations with trusts: when the beneficiaries have received property from an estate or trust and want to buy separate replacement properties, or they want to sell and purchase a replacement property together, but can't obtain the necessary financing because many lenders won't accept a trust as the borrower.

What can be done? As an example of the first entity issue, Fran, Mike, and Jan each were equal beneficiaries under a trust established by their parents. The trust had received an attractive offer on a parcel of land held for many years. All three siblings wanted to sell, but each preferred to purchase a replacement property individually. What can be done?

One solution is to deed a one-third percentage interest in the relinquished property to Fran, Mike, and Jan; each then can sell his or her portion of the relinquished property to the buyer. This solution allows them to go forward individually and either recognize any potential tax consequences from the sale or acquire their own replacement property (Revenue Ruling 92-105, 1992-2 CB 204).

The second entity issue sometimes arises when all beneficiaries want to exchange into a more expensive replacement property. Because the replacement property price is greater than the proceeds generated from the sale of the relinquished property, a loan is needed to make up the difference. The problem arises when the beneficiaries cannot locate a lender willing to make a loan to the trust.

The solution is similar to the first example. Fran, Mike, and Jan each can receive a deed for a one-third share in the relinquished property and transfer them to the buyer at closing. When it is time to purchase the replacement property, they can use their equal shares of the proceeds to purchase and take title to the replacement property as equal tenants-in-common. In this way, they can obtain the funds required to complete the purchase from the lender, because they will be named as co-borrowers on the loan. Later, if they desire, they can deed their interests back to the trust.

Exchanges Involving Corporations
A similar entity issue arises when a corporation owns property that is being sold and not all of the stockholders want to do a tax-deferred exchange.

Assume that a corporation with two 50 percent stockholders is selling property. Bob would like to exchange into other property, while Jerry wants to sell and pay any taxes that might be due. In order to meet the requirements to complete an exchange successfully, Bob cannot take his share of the proceeds from the sale of an asset held by the corporation and acquire replacement property solely in his name. Further, if the corporation is dissolved and the property is distributed to the stockholders, it triggers the gain. Although the IRS issued several favorable rulings prior to 1986 in which a taxpayer dissolved a corporation and successfully completed an exchange, the Tax Reform Act of 1986 repealed IRC 333 so that a corporation no longer could liquidate and distribute appreciated property to its shareholders without triggering a taxable event.

Is there a creative alternative that could salvage the possibility of an exchange? Could Bob buy Jerry’s stock so that he would own 100 percent of the corporation, sell the relinquished property, and buy replacement property in the corporation’s name? This may be feasible if Bob has both the desire and financial resources to buy out Jerry’s interest. But in order to do this, Bob also must be comfortable acquiring a replacement property that is worth two times the value of his current stock.

Exchanges Involving Partnerships
The same issue could arise in a partnership when a number of partners have different goals. For example, a partnership bought a parcel of land several years ago that has appreciated greatly in value. A potential buyer has made an attractive offer on the land and the partnership wants to sell. Of the three partners, only two want to

exchange into other property. The remaining partner wants to cash out. What strategy will satisfy the desires of all three partners?

In a technique that has been coined the "dissolution solution," a partnership can be dissolved and the partners each can receive a distribution of real estate without triggering a taxable event. Employing this strategy, a partnership could dissolve and distribute to each partner a pro rata percentage interest in the property. The former partners then could enter into a contract with a buyer to sell the property. At closing, the relinquished property would be conveyed by these individuals to the buyer in three separate deeds. The two former partners who want to complete an exchange could acquire their own separate replacement properties, while the other partner could take cash proceeds from the sale.

Although increasingly common, the dissolution solution raises potentially troubling issues. The most prevalent concern with this strategy is whether it violates the held-for-investment rule, which says that to complete a valid exchange, the exchanger’s intent must be to hold both the relinquished and replacement properties for investment. Some tax professionals argue that if a partnership is dissolved, property is distributed to the former partners right before a sale, and the partners separately convey the interest in the property that they just received, then the intent to hold the relinquished property has not been sufficiently established. With this requirement in mind, is there a safer strategy?

When the partnership can anticipate that a majority of the partners want to acquire replacement property separately in an exchange scenario, they should consider dissolving the partnership. This step should be implemented no later than the tax year before the year in which the sale of the relinquished property might occur. Although this is one option to meet the held-for-investment requirement, some tax professionals remain concerned that the IRS still might deem the new co-tenants effectively to be a partnership for tax-reporting purposes. To further document its intent, the partnership also should consider making an election under Treasury Regulation 761(a) not to be treated as a partnership for tax purposes.

Another possible solution is to sell the relinquished property and structure half of the proceeds from the sale in the form of a note to the partnership. At a future time, the two partners wanting to execute an exchange could distribute the note to the nonexchanging partner for his 50 percent stake in the partnership. One of the terms of the note would call for an immediate short-term balloon payment. Once given to the nonexchanging partner, it immediately would be repaid. In this scenario, all of the parties are satisfied: Two partners can go forward and exchange while the other cashes out.

The example of Caroline, Andy, and Paul shows how one partnership handled a tricky exchange situation. The three bought a piece of property together in 1994 and formed a limited partnership called CAP for the acquisition. Caroline and Andy both had a 25 percent partnership interest, with Paul holding the remaining 50 percent interest. Later that year, CAP bought a parcel of raw land for $500,000.

Over the next five years, an explosion of development occurred in the area. The value of CAP’s land rose dramatically. Recently, the partners received an unsolicited offer of $1 million for the parcel. When they met to discuss the offer, it soon became clear that both Caroline and Andy wanted to sell the land and reinvest in other property, but Paul preferred to sell and cash out. Caroline expressed an interest in purchasing a small apartment building, while Andy wanted to roll the dice on land again. With these different objectives, they turned to an exchange expert and their tax professional for some advice.

To accomplish their objectives to sell the land and go forward either to complete a tax-deferred exchange or cash out, some strategic planning was necessary. They decided not to accept the pending offer, believing the land was very marketable.

First, the partners decided to try the dissolution solution. They elected to dissolve the partnership in February and distribute pro rata percentage interests in the land to each partner. Upon advice from their tax professional, they filed an election under Treasury Regulation 761(a) to be treated as individual owners. Finally, they entered into a co-tenancy agreement that outlined their individual responsibilities relating to the land.

The next year, they listed the property and quickly received an offer for $1.1 million. The sales contract correctly listed each of them as individual sellers. When the transaction closed, Caroline and Andy used a qualified intermediary to set up their tax-deferred exchanges. They deeded their ownership interests in the property to the buyer for $275,000 each and started pursuing their respective replacement properties. Paul sold his 50 percent interest in the property for $550,000, which he received in cash at closing. With the help of knowledgeable professionals and some strategic advance planning, the varying goals of all three partners had been achieved.

Exchanges for Percentage Ownership

Another common entity issue arises when an exchanger wants to buy a percentage interest (as a partner or member of an LLC) in a larger replacement property. In this situation, the exchanger would not actually take title to the replacement property but would acquire an interest in the partnership that would take title to the property. A partnership interest may not be considered qualified property in a tax-deferred exchange, according to Section 1031(a)(2)(D).

Strategies exist to overcome this entity issue and still complete a successful exchange. In one scenario, the exchanger can take title to a percentage of the replacement property as a tenant-in-common with the partnership, enter into a co-tenancy agreement governing the operations of the property, and then complete the exchange. Although this may be feasible in theory, in actual practice, many potential partners or lenders may be uncomfortable with such a complicated ownership structure.

Another potential answer is for the exchanger to take title to part of the replacement property and immediately contribute it to the partnership for a percentage ownership interest. Although this technique occasionally is used, the question of whether the exchanger intended to treat the replacement property as held for investment arises again. There is concern that this is not the exchanger’s true intent if the property immediately is conveyed to the partnership.

Possibly a more defensible solution is for the exchanger to acquire the land that the partnership wants to develop and lease it to the partnership. During this holding period, the partnership would pay rent to the exchanger in an amount approximating a reasonable return on investment. In order to make the arrangement more attractive, the partnership agreement also might provide for a preferred return to the exchanger on the residual value if and when the underlying property and improvements eventually are sold. These additional steps are more complicated and costly to execute. They bear consideration, however, if the parties have strong motivations to meet the exchange requirements and can craft a mutually beneficial business arrangement.

Plan Ahead

For the best chance of completing a successful tax-deferred exchange, it is important to outline the entire transaction being contemplated, highlight any entity problems in advance, and include a qualified tax professional in the planning process. It is much more difficult to address entity issues successfully once the transaction begins. Identifying them in advance and implementing strategies to solve them will facilitate a successful exchange with all the related benefits.