1031 DELAYED EXCHANGES: AVOIDING COMMON TRAPS

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Code Section 1031 exchanges of real estate are relatively common, and in most cases there is very clear guidance about how they should be structured. There are also several knowledgeable advisors in the area, including companies which specialize in providing "accommodator" services for 1031 exchanges. Nonetheless, there are a number of common situations that, if not handled properly, can inadvertently trigger gain. This article reviews some of such common traps and how to avoid them.

Before reviewing such situations, a review of the basic rules for exchanges and delayed exchanges will be helpful. In order to qualify for an exchange, both the relinquished property and the replacement property must be of "like kind." This means both properties must be held for trade or business or for investment. The types of properties that qualify as "like kind" are quite broad, meaning that a farm property may be exchanged for an apartment building, or a shopping center may be exchanged for raw land.

As far as the "holding for trade or business or for investment" element, the test is subjective. Proving someone's intent, including changes in their intent over time, may prove troublesome in certain circumstances. Finally, both the selling taxpayer and the purchasing taxpayer must be the same, which is discussed more below.

As far as delayed exchanges, there are some important timelines. Qualifying replacement property must be identified in writing by midnight on the forty-fifth day after the sale date. In addition, the taxpayer must close on the replacement property on the earlier of 180 days after the sale date, or the due date of the seller's tax return (counting extensions of time to file), if earlier.

Any time there is a delayed exchange, the taxpayer must use a "qualified intermediary"—an accommodator. The seller must never touch or have access to sales proceeds. Instead, the accommodator holds the money and uses it to acquire replacement property. Thus, in any delayed exchange, the written identification of replacement properties must be made to the accommodator. In addition, there are limitations on the number of replacement properties that can be designated. These rules are beyond the scope of this article, but they are contained in Treasury Regulation Section 1031 (k)-1(c)(4).

The first potential trap in many 1031 exchanges is the forty-five-day identification requirement. You should urge your clients to be looking for, tying up, and finishing due diligence on their replacement properties even before the sale of their existing property is completed. The reason for this advice is that if a client waits too long, designates a replacement property in a timely manner, but then discovers a problem—for example, they find that their intended replacement property sits on the site of an abandoned nuclear waste dump—they will be forced to recognize gain, even if they are successful closing on another property by the closing deadline described above.

Another trap is that posed by the potential shortening of the replacement period if a tax return is filed during a pending exchange. One of the authors was an expert witness defending a CPA in a malpractice case where the CPA filed the taxpayer's tax return prior to the time the taxpayer had acquired their replacement property, even though the replacement property was acquired prior to the expiration of the 180-day deadline. The reason for the early filing of the return was that the CPA was informed about the expected closing date for the replacement property acquisition.

> [D]espite relatively clear guidance about how to structure successful 1031 exchanges, there are some pitfalls present in a number of common circumstances involving tax deferred exchanges.

Unfortunately, when the closing date was postponed, no one (neither the taxpayer nor the accommodator) informed the CPA. Thinking the purchase had closed, the CPA forwarded the return to their client. Not knowing the rule, the client authorized the CPA to file the return. This example illustrates the critical need for communication with tax return preparers in situations where the acquisition of a replacement property straddles a year end.

As an example of how the 180-day replacement period can be shortened, for a calendar year LLC (which normally has a return due date of March 15 of the following year), if the LLC sells a property on December 31, 2022, the LLC must acquire its replacement property by March 15, 2023, unless the LLC files for an extension. If the LLC files for an extension, the normal 180-day rule would apply, meaning that if the replacement property has not been purchased yet, the LLC must file for extension to preserve the tax deferral.

Another potential trap is the "same taxpayer" rule. Assume your client holds property in a disregarded entity—for example, a solely owned LLC that is treated as if your client is the direct owner of the property. However, the client is married, and their spouse is an equal owner of the LLC under California community property rules. The property is sold by the disregarded entity, and the client's individual tax identification number is used on both the sales documents and on the designation by the client of their replacement property to their accommodator.

Now assume that following the sale, the client's CPA decides that it makes sense for the client to take advantage of the elective pass-through entity tax, which allows an entity taxed as a partnership or S corporation to make an elective tax payment of 9.3% of the entity's "qualified net income." The purpose of the election is to avoid the current $10,000 federal limitation on the deductibility of state and local income taxes applicable to individuals.

To qualify for the election, the CPA elects to treat the previously disregarded entity as a partnership. Unfortunately, by doing so, the client has probably violated the "same taxpayer" rule, because they sold the property as a disregarded entity (i.e., as an individual) and acquired it as a partnership—a different tax entity. Under these circumstances, it is likely the Internal Revenue Service (IRS) or the Franchise Tax Board (FTB) would assert that, despite the identical ownership interests in the LLC both before and after the exchange, because there is a new taxpayer (the LLC that was disregarded, but is now treated as a partnership), the same taxpayer rule has not been satisfied. Again, communication between your clients and their tax preparers any time an exchange is involved can avoid expensive problems.

The same taxpayer issue is a common one any time a partnership or LLC is selling property, and only some of the partners or LLC members are interested in a 1031 exchange, while other partners or members are interested in cashing out. Many times, the so-

called "drop and swap" transaction proposed as a solution to this situation will not work. Before discussing the issues, the typical "drop and swap" transaction involves the partnership or LLC distributing out its properties to its partners or members as tenants in common. Normally this distribution is tax-free under the partnership tax rules. The tenants in common then individually enter into the sale transaction, with each deciding on their own whether to take the cash and pay tax or use an accommodator to hold the cash and try to do their own exchange.

The first issue with "drop and swaps" is that it is very easy for the IRS or the FTB to claim that although the partnership or LLC met the "holding for trade or business or for investment" test, the individual tenants in common did not. They acquired the property for the purpose of selling it to the buyer, not holding for trade or business or investment.

You should note that Form 1065, (U.S. Return of Partnership Income) asks, in question 11 of Schedule B, whether, "during the current or prior tax year, the partnership distributed any property received in a like-kind exchange or contributed such property to another entity." Question 12 on Schedule B asks whether, "at any time during the tax year," the partnership distributed to any partner a tenancy in common or other undivided interest in partnership property. Clearly, the IRS is tracking this issue.

One solution is to distribute the property that is going to be sold out to the partners as tenants in common, enter into a tenancy-in-common agreement, and make sure all the tenants in common hold the property for a considerable length of time prior to any sale. The problem with this approach is that no one can answer the question, "How long should the property be held as tenants in common"? In any situation where a potential buyer has approached a partnership wanting to buy its property, the "drop and swap" solution is already too late. In addition, there are numerous practical problems to holding property as tenants in common, including the difficulty in having the tenancy in common be respected as such (as opposed to being re-characterized as a partnership for tax purposes) and the loss of liability protection.

The IRS guidelines for qualifying an undivided interest in rental real estate as holding the property as individual co-owners, as opposed to holding the property as a separate entity for federal tax purposes, are contained in Rev. Proc. 2022-22, 2002-14 IRB 733 (Apr. 8, 2002). The guidelines are for advance ruling purposes, meaning that they are very strict, but many of the conditions are completely impractical for owning real estate with other parties. For example, to avoid having the IRS recast the arrangement as a tax partnership, each co-owner must have the rights to transfer, partition, and encumber their individual ownership interest, "without the agreement or approval of any person." There are numerous other restrictions that make the joint ownership and operation of property through tenancy in common interests very challenging.

A better solution to the partnership sale issue is to have the existing partnership sell the old property and acquire the replacement property. That way, the same taxpayer rule is met. The taxpayer identification numbers on all the documents will match, and there will be no red flags apparent on the partnership's responses on Schedule B of the partnership's partnership tax return. At some point, those partners who desire to receive cash can be redeemed out of the partnership, leaving the "same taxpayer" intact with the remaining partners who wish to continue. Of course, satisfying the timing requirements of those partners who wish to cash out will still be a challenge.

The difficulty of the proposed partnership sale where some partners wish to continue in a real estate investment while others want cash is illustrated *In the Matter of the Appeal of Sharon Mitchell*, a California Office of Tax Appeals case (OTA Case No. 18011715, August 2, 2018). *Mitchell* is a non-precedential case where, rather remarkably, the OTA allowed a 10% general partner of a real estate partnership to receive a tenancy in common interest in the partnership's real estate just prior to a sale, followed by an immediate exchange by the taxpayer who received the tenancy in common interest from the partnership. Perhaps the OTA considered a general partnership as equivalent to each individual partner's ownership, even though each partner is technically a separate taxpayer from the general partnership.

However, reliance on *Mitchell* is very risky since there was a strong dissent and the decision is non-precedential. In addition, in a separate proceeding, the taxpayer in *Mitchell* attempted to recover their attorney fees from the FTB and was denied. The OTA stated that the FTB position in *Mitchell* had substantial authority, showing just how close the decision was.

The subjectivity of the "holding for trade or business or investment" test is also a potential trap. Consider a client who has held vacant land for twenty years expecting it to appreciate. However, just before their anticipated sale of the land, a local broker advises your client that they will realize much more for their land if they subdivide it before sale. Under these circumstances, the IRS or the FTB can claim that your client no longer held the land for investment but had become a "dealer" in subdivided lots, disqualifying the proposed sales for 1031 treatment. Some advance planning in these circumstances may help since there is case authority dealing with how far one can go in entitling or developing property without becoming a "dealer."

Another potential trap with the subjective intent test involves how long property is held. The authors are frequently asked "what is the holding period" for property to qualify as being "held for investment"? The correct answer is "it depends." A property held for ten years may not qualify if the taxpayer always intended to sell it (as evidenced by factors such as having open brokerage listings on the property). By contrast, someone can qualify the "holding" requirement if they acquire property in October and sell it in November if they originally acquired the property for investment, and thereafter sold it to a buyer who offered an attractive price and profit to the original owner.

1031 exchanges in general, and especially tax deferred exchanges, present valuable benefits. Making sure clients satisfy each of the requirements is important, as is clear communication and coordination with all advisors.

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