

# MANN<sup>TM</sup> REPORT

| THE PEOPLE BEHIND THE DEALS IN THE NY REAL ESTATE SCENE |

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## Asset Preservation, Inc.

### Creating Optimal §1031 Exchange Ownership Structures

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Investors are discovering that many of the ways they have traditionally invested in real estate do not serve them well if they wish to pursue a tax-deferred exchange when they decide to sell. Given the fact that many investors are holding highly appreciated real estate in their portfolios, the discovery that they may be unable to take advantage of a §1031 exchange to shelter their gain on the sale of the real property may come as an unwelcome surprise. §1031 requires that an investor own a direct real property interest to defer gain in a real property exchange. Further, the Code specifically excludes certain types of property from use in an exchange. Included among these excluded property types are stocks, partnership interests, and most types of beneficial interests in trusts. Often, when one or more investors seek to co-invest in real estate, they will form an LLC or partnership to take title to the property.

Historically, co-investors sometimes took title in C or S corporations but holding title in such entities has declined significantly in recent years as LLCs have gained popularity. In any event, where ownership is vested in such entities and the investors decide to sell their highly appreciated real estate and wish to perform an exchange, with limited exception, the investors must collectively do so at the entity level, meaning the partnership, LLC, S corporation, or C corporation, must stay intact to perform the exchange. The partners, members, or shareholders cannot individually perform an exchange and acquire replacement property independently of the other investors. This result is due to that fact that an investor owning an interest in a partnership, LLC, or corporation technically owns a partnership interest or membership interest or a share of stock, all of which are personal property and excluded by law from use in a tax deferred exchange.

In some instances, a partnership or LLC may be able to restructure the manner in which ownership is held in a way that results in each of the investors owning a tenant in common interest in the property. If the restructure is completed before an exchange, each of the tenants in common may have the option to either cash out on the sale of the

property or perform an exchange with their pro-rata share of the proceeds independent of the other investors. However, there are risks and costs inherent in restructuring ownership that may be avoided if the investors initially establish an ownership vehicle that provides each of the owners with the ability to perform an exchange. For instance, to restructure, the partnership or LLC must generally deed the property pro-rata to investors. In many jurisdictions, transfer tax may be due on such transfer. Further, restructuring ownership on the eve of the sale of the property in order to permit independent exchanges might result in the exchange being overturned in the event of audit if it is determined that the tenants in common did not hold title for a sufficient time period to qualify as having held property for investment purposes as required by the Code.

Finally, C corporations and S corporation cannot be restructured to allow individual shareholders to take advantage of a tax deferred exchange independent of the corporation. Shareholders in such entities regrettably find that they have few tax deferral options in the event of the sale of highly appreciated property.

Thus, investors should consult carefully with their legal and tax advisors when considering what form of ownership to create to take title to real property and when co-investing with others. In addition, where an investor is investing in an existing project or entity, the investor should consider whether the form of investment dictated by the current structure of the project or entity will unnecessarily restrict the investor's future tax deferral options, as in the case with limited partnerships.

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