

IRS Provides Guidance in Structuring 1031 Like-Kind Exchanges Involving Undivided Fractional Ownership Arrangements

Like-kind exchanges are popular ways for taxpayers to dispose of appreciated realty without paying a current tax. However, it may be difficult for a taxpayer that finds a willing buyer for his property to find suitable replacement property within the statutory time periods (identification of replacement property no later than 45 days after the transfer of the relinquished property, and receipt of the replacement property within 180 days after the transfer or by the extended due date of the return for the year of transfer if earlier). One solution is to replace the relinquished property with an undivided fractional interest in like-kind realty (also known as a marketable tenancy-in-common interest). These interests are set up to give a trouble-free return to investors through the use of triple-net-leases and management companies that handle all the day-to-day details of running the property.

The problem is that IRC Section 1031 like-kind exchanges do not apply to exchanges of stock or partnership interests. Therefore, in structuring a like-kind exchange using undivided fractional interests, one must be very careful to structure the transaction so that the IRS does not reclassify it as an exchange of interests in a business entity. Were this to happen the tax-free nature of the exchange would be repudiated.

The IRS first provided guidance on this form of a 1031 transaction in Revenue Procedure 2002-22. This Revenue Procedure set forth when the IRS would rule that undivided fractional interests were not interests in a business entity and would therefore qualify for 1031 treatment. The Revenue Procedure also provided a list of necessary documents, materials and information required for a favorable ruling.

The first ruling issued under Revenue Procedure 2002-22 was Private Letter Ruling 200327003. The guidance provided therein was pretty bare bones, but set forth a number of factors that must be present for a transaction using undivided fractional interests to qualify for 1031 treatment. These included, but are not limited to, a written tenancy-in-common agreement; no more than 35 tenants-in-common (none of whom may be a partnership – single member LLC's may qualify); centralized management; exclusion of the tenants from Subchapter K of the IRC; and a limitation on possible business activities outside of rental real property.

However, in the recent IRS Private Letter Ruling 200513010 the IRS supplied a fairly detailed blueprint for real estate entrepreneurs to follow in structuring undivided fractional interest ownership arrangements that will pass muster with the IRS and qualify for favorable 1031 treatment. In addition this new Private Letter Ruling involved a far more detailed structure and governing agreement than that described under Private Letter Ruling 200327003. This is very favorable to the real estate entrepreneur. It allows for more sophistication in planning while still achieving a tax-free exchange.

Structuring a 1031 like-kind exchange with undivided fractional interests is rich with possible pitfalls and traps for the individual or attorney who is not well versed and experienced in setting up such transactions. Please contact Jason S. Rudnick (860-275-6807) if you have any questions or concerns about this article.