

SHOPPING CENTER BUSINESS™

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NEW LIKE-KIND EXCHANGE CONSIDERATIONS

Many real estate investors utilize a provision under the Internal Revenue Code allowing for tax deferred “like-kind exchanges” of real property (known as Section 1031 exchanges). Under this arrangement, a property owner may sell business or investment property, and upon compliance with certain procedures, utilize the proceeds from that sale to acquire replacement real estate also used for business or investment purposes. By utilizing the Section 1031 procedure, a seller is able to defer the gain (and consequently, the income taxes) on the sale of the real property until a subsequent sale of the replacement property (at which time a further 1031 exchange may be available for further tax deferral).

Section 1031 exchanges are frequently carried out by purchasing replacement real estate in the form of an undivided tenancy-in-common (or TIC) interest in real property, where several owners separately hold undivided interests in a single parcel of property. In addition, partnerships and limited liability companies often combine the distribution of TIC interests with Section 1031 exchanges to maximize individualized tax planning. Although the IRS considers a number of specific factors in determining whether or not to recognize a particular transaction or ownership arrangement as valid for Section 1031 exchange purposes, there remains some ambiguity, and thus flexibility, in structuring these transactions. Further, the IRS, in the past, has not regularly scrutinized Section 1031 transactions. However, recent events may serve as a harbinger of changes to come.

The IRS has been working on a project to revise IRS Form 1065, which is the tax return filed by partnerships and other entities such as limited liability companies that are taxed as partnerships. Beginning with the 2008 tax year, the revised partnership tax form requires these entities to disclose certain Section 1031 and TIC transactions that were not required to be disclosed in the past. Specifically, the IRS has added, beginning for the 2008 tax year, two new line item disclosures relating to Section 1031 exchanges and TIC distributions as follows:

“13. Check this box if, 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 (including a disregarded entity).”

“14. At any time during the tax year, did the partnership distribute to any partner a tenancy-in-common or other undivided interest in partnership property?”

These new specific and conspicuous disclosure requirements insinuate the IRS’s intent to take a closer and more concentrated look at certain Section 1031 like-kind exchange activities. Such scrutiny may foreshadow coming IRS enforcement actions, a development that real estate investors in particular should carefully consider when structuring their Section 1031 exchange transactions.

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