Income Tax Deferral – the First Real Estate Exchange Fund

Section 1031 of the Internal Revenue Code (the "Code" or the "IRC") [1] as amended by the Tax Cuts and Jobs Act of 2017 (the "Act"),[2] provides that no gain or loss shall be recognized on the exchange of real property held for productive use in a trade or business, [3] or for investment, if such real property is exchanged solely for real property of a like kind which is to be held either for productive use in a trade or business or for investment.[4] The property that the taxpayer gives up is frequently called the "relinquished" property and the property that the same taxpayer receives is frequently called the "replacement" property. In general, such a transaction is known as a like kind exchange. However, the relevant law is fraught with traps for the unwary; for example, gain will be recognized if the taxpayer receives boot[5] in addition to the replacement property. Losses are not recognized.[6]

Section 1031 exchanges have been a long-time feature of the Code and were originally created in 1921. The goal was to allow tax exempt treatment for transactions that are essentially continuations of the taxpayer's primary investment in different but similar property (because the taxpayer's funds are still tied up in a similar investment).[7] The primary purposes were to avoid unfair taxation of ongoing investments in property and to encourage active reinvestment. The statute and related regulations have been altered numerous times over the years, with the most recent revision effected by the Act. One of the most significant changes authorized by the Act is that § 1031 now applies only to real property; it no longer applies to personal property (*e.g.* bulldozers, trucks, machines, etc.).

The general rule with respect to gain or loss realized upon the sale or exchange of property determined under § 1001 (gain and loss on sale of property) is that the entire amount of such gain or loss is recognized except in cases where specific provisions of subtitle A of the Code provide otherwise. Exceptions to the general rule are construed strictly; the exceptions from the general rule requiring the recognition of all gains and losses do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is only accorded by the IRC if the exchange satisfies (i) the specific description in the IRC of an excepted exchange, and (ii) the underlying purposes for which such exchange is excepted from the general rule.[8] Generally, the taxpayer claiming the benefit of any exception bears the burden of proof.

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[1] All references are to the Internal Revenue Code of 1986, as amended, as in effect on April 25, 2019.

[2] The Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97.

[3] The Act restricted eligible property to real property only.

[4] Real property held for sale is specifically excluded per § 1031(a)(2).

[5] Any property besides property of a like kind to the relinquished property. For example, cash or stock constitute boot per § 1031(b). A net reduction in liabilities constitutes boot.

[6] Sec. 1031(c).

[7] *Jordan Marsh Co. v. Commissioner*, 269 F2d 453 (2d Cir. 1959).

[8] Treas. Reg. § 1.1002-1.

In order to qualify for tax free treatment under § 1031, a transaction must satisfy several conditions. The "touchstone" of § 1031 requires an exchange of like kind business or investment properties as distinguished from a cash sale of property by the taxpayer and a reinvestment of the proceeds in other properties.[9] A § 1031 transaction requires strict adherence to the rules as even minor deviations may remove such transaction from the § 1031 exception to § 1001.

Handler Thayer, LLP attorneys recently authored a tax memorandum regarding a new method of employing the tried-and-true § 1031 exchange. The Master Tenancy™ method is structured in a manner very similar to that of a traditional, standard real estate fund common in the market today. The difference between the Master Tenancy™ structure and a traditional fund structure is the ability to accomplish three key objectives: (i) to provide continued tax deferred growth in an evergreen format, (ii) to use best-in-class operators with the ability to switch operators without affecting the tax consequences to the other investors, and (iii) to allow a local operator, Limited Partner or General Partner access to capital, particularly, to allow a promote,[10] without affecting the tax consequences to the other parties.

By continually exchanging like-kind properties, the Master Tenancy™ method can achieve its objectives. The method, in general, involves continually exchanging into value-add properties; the goal is not to operate rental properties (which would generate taxable income). Instead, by utilizing § 1031's tax deferral powers, the Master Tenancy™ method defers a taxation event until far into the future. Taxes are only recognized upon the sale (not exchange) of a property or one or more fund units. This allows wealth to be passed from generation to generation with minimal taxation.

While no strategy is without risk, the Master Tenancy™ method may provide a new and valuable tax deferral opportunity for transmitting wealth to future generations that is both statutorily authorized and tax-advantaged. Please contact us to learn more about this tax strategy, or other tax strategies and long-term intergenerational wealth transfer strategies.

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[9] _Barker v. Commissioner_, 74 TC 555 (1980).

[10] A promote is similar to a carried interest or profits interest; the term describes the disproportionate share of profits due to a sponsor.