Tax Issues in Real Estate Transactions

Dallas Bar Association

Real Estate Section

February 9, 2015

Todd D. Keator

Thompson & Knight LLP

214-969-1797

todd.keator@tklaw.com

Agenda

- Capital Gain Planning
- Net Investment Income
- Dealer vs. Investor (and Bramblett Structures)
- 1031 Exchanges and “Drop & Swaps”

Capital Gain Planning

- Tax Rates
  - Short Term = One year or less = ordinary income rates (39.6%).
  - Long Term = More than one year = 20.0%
  - NII Tax = 3.8%.
  - Recapture:
    - Ordinary (39.6%) or
    - Sec. 1250 gain at 25.0% (for most real estate).
- Sale of interest in partnership or LLC = same result (look through rule). Contrast S corporations (no look through for 1250 gain).
- 1031 Exchange? [Can result in 0% tax!]

*Take away: Hold for more than one year and try to avoid NII.

Net Investment Income - Background

- Effective 1/1/13, Sec. 1411 now imposes a new 3.8% “medicare contribution tax” on “net investment income” (NII).
- Enacted as part of the Health Care and Education Reconciliation Act of 2010 (P.L. 111-152, 124 Stat. 1029).
- Contained in new Chapter 2A of the Internal Revenue Code

Overview

- 3.8% tax on NII only of individuals, trusts and estates.
  - No corporations or REITs.
- Mirrors the 3.8% medicare portion of SE tax.
- Stated purpose is to impose a tax on "unearned income or investments" of certain individuals, estates and trusts.
- Chapter 1 principles generally apply (gain deferral or exclusion, loss limitations, etc.).

Individuals

- 3.8% NII tax applies to lesser of:
  - "Net investment income" for the year or
  - Modified adjusted gross income over the "threshold amount."
- Threshold amount = $200k (single) or $250k (married) ($125k married filing separate).
- NII tax subject to individual estimated tax provisions.

What is "Net Investment Income"?

- The sum of:
  - interest, dividends, annuities, royalties, and rents (other than such income which is derived in the ordinary course of a trade or business not described in 1411(c)(2) (the "Ordinary Course" exception); ("Bucket 1")
  - other gross income derived from a trade or business described in 1411(c)(2); ("Bucket 2")
  - net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business not described in 1411(c)(2). ("Bucket 3")
- Minus deductions that are "properly allocable" to such gross income or net gain.

“Ordinary Course” Exception

- Exception for bucket 1 “income” derived “in the ordinary course of a trade or business” and bucket 3 “net gain” from the disposition of “property held in a trade or business,” in each case where the trade or business is not described in § 1411(c)(2).
- A trade or business is described in § 1411(c)(2) if such trade or business is—
  - a passive activity (within the meaning of section 469) with respect to the taxpayer, or
  - a trade or business of trading in financial instruments or commodities (as defined in section 475(e)(2)).

NII and Real Estate

- NII includes:
  - Rental Income;
  - "Net gain" from the disposition of real estate;
    - Excludes items not included in taxable income. Examples:
      - (1) Gain excluded under § 121 from the sale of a principal residence;
      - (2) Gain deferred under § 1031 or 1033.

"Ordinary Course" Exception Applied to Real Estate

- Ordinary course exception is a 2-part test:
  - (1) Is the rental income or net gain derived in a trade or business?
  - (2) Is the taxpayer "passive" with respect to that trade or business (as determined under § 469)?
- If Taxpayer fails either prong, then the income or net gain is subject to 3.8% NII tax.

Quick Note About Passive Activity

- Generally, any trade or business in which the taxpayer does not materially participate ("MP");
- Seven MP tests: (1) 500 hours; (2) "substantially all" participation; (3) more than 100 hours and not less than anyone else; (4) "significant participation activities" over 500 total hours; (5) five of ten test; (6) "personal service activity" and (7) facts and circumstances and 100+ hours.
- Limited partners limited to tests (1), (5) and (6).

Rental Activity as Passive

- Rental activity is *per se* passive, unless an exception applies.
  - Thus, rental activities presumptively fail the "ordinary course" exception, unless a 469 exception applies and the activity is a trade or business.
- Key Exceptions:
  - Real estate professional;
  - Grouping rules;
  - Passive to "non-passive" recharacterization rules (e.g., self-rental rule);
  - Rental to "non-rental" recharacterization rules.

NII Examples

1. Taxpayer (TP) is a lawyer who owns a townhome that is leased to an individual tenant. Assume TP is passive (i.e., no MP). Does TP's net rental income constitute NII? Is TP's net gain on a sale also NII?

- Yes and yes. NII generally includes both "rents" and "net gain" attributable to the disposition of property (among other investment items). I.R.C. § 1411(c)(1)(A)(i) and (iii).
- *Key Exception*: NII excludes rents derived in the ordinary course of a trade or business, and net gain from the disposition of property held in a trade or business, in each case where the trade or business is not a passive activity (within the meaning of § 469) with respect to the taxpayer (the "Ordinary Course Exception"). Note the two prongs of the exception:
  - Must be a trade or business;
  - TP must not be passive in the trade or business.
- Here, the rent is by definition NII, and the ordinary course exception cannot apply because TP is passive.
- Note that the "trade or business" question is not even reached where the TP is passive.

2. Same as (1), but now assume TP is not a lawyer and instead is a "real estate professional" who is <u>not</u> passive and who operates the rental property in a trade or business. Does TP's net rental income constitute NII? Is TP's net gain on a sale also NII?

- No and no. NII generally includes both "rents" and "net gain" attributable to the disposition of property (among other investment items). I.R.C. § 1411(c)(1)(A)(i) and (iii).
- But here, the Ordinary Course Exception applies, because the example assumes that the property is held in a trade or business and that the TP is not passive with respect to such trade or business.

3. TP owns a small apartment complex leased to residential tenants. The apartments constitute a trade or business. TP works 2,000 hours per year at the apartments. Does TP's net rental income constitute NII?

- No, under the Ordinary Course Exception. Under § 469(c)(2), rental income generally is *per se* passive. However, under § 469(c)(7), rental real estate activity is not *per se* passive if the TP is a "real estate professional." TP will be a real estate professional if:
  - More than ½ of the personal services performed in trades or business by the TP during the year are performed in "real property trades or businesses" in which the TP materially participates; and
  - TP performs more than 750 hours of services during the year in "real property trades or businesses" in which the TP materially participates.
- For this purpose, a "real property trade or business" means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business." I.R.C. § 469(c)(7)(C).
- Here, TP meets the definition of a real estate professional, with the result that TP is allowed to test for material participation. Here, TP participates more than 500 hours, which is sufficient for "material participation." Treas. Reg. § 1.469-5T(a)(1).

4. TP, a full-time physician, operates a medical practice through an S corporation in which she materially participates. TP constructs a new medical office building and leases it to the S corporation at a rental sufficient to create net passive income from the rental of the building that she hopes (incorrectly) can be offset with passive losses from other sources. The two activities are not grouped. Is the rental income NII?

- No. Is the income passive? No. *See* Treas. Reg. § 1.469-2(f)(6) (self-rental rule), which treats an amount of gross income from an "item of property" used in a rental activity equal to the net rental activity income derived from the property for the year "as not from a passive activity," provided the property was rented for use in a trade or business activity in which the taxpayer materially participated for the taxable year.
- TP's material participation is N/A.
- Is the income from a trade or business? Preamble to Proposed Regulation said no, but the Final Regulations reverse this position with a new safe harbor treating rental income that is nonpassive under the self-rental rule as being derived from a trade or business.

5. Husband (H) is the sole shareholder of an S corporation that conducts a grocery store trade or business. Wife (W) is the sole shareholder of another S corporation that owns and rents out a building. Part of the building is leased to the grocery store business. H and W are treated as a single individual under the passive loss rules. Is the rental income NII?

- Maybe. Does the Ordinary Course Exception apply? If the rental activity constitutes a trade or business (and the facts do not indicate otherwise), the issue is whether TP is passive or non-passive. The rental activity is *per se* passive, unless an exception applies. If the rental activity can be grouped with the trade or business activity, the real estate activity is no longer *per se* passive, and TP may test for MP.
- A rental activity may be grouped with a trade or business activity only if the activities constitute an "appropriate economic unit" and if either (i) the rental activity or the trade or business activity is "insubstantial" in relation to the other, or (ii) each owner of the trade or business activity has the same proportionate ownership interest in the rental activity. *See* Treas. Reg. 1.469-4(d)(1)(i).
- Here, H and W are treated as a single owner, thus the proportionate ownership test in (ii) above should be met, meaning the rental activity and trade or business activity likely may be grouped into a single activity. *See* Treas. Reg. § 1.469-4(d)(1)(ii)(ex. 2) (finding a "single trade or business activity"). If TP has MP in the grouped activity, it would not be passive, and the Ordinary Course Exception would apply.
- New safe harbor deems the nonpassive rents to be from a trade or business.

Dealer vs. Investor

- Common question is whether TP holding real property is an “investor” or a “dealer” with respect to the property. Character of gain depends on whether TP is an investor or a dealer.
  - Investor = capital gain (long or short)
  - Dealer = ordinary income
- Same TP can be both a dealer and an investor for different properties (dual role).

*Clients want to avoid dealer status.

Dealer Test

- Property held as “inventory” or for sale to customers “in the ordinary course of a trade or business” is dealer property.
- The 5th Circuit uses the following 3-prong test:

1. First, whether the TP was engaged in a trade or business, and if so, what business;

2. Second, whether the TP was holding the property for sale in that business;

3. Third, whether the sales were “ordinary” in that business.

- *See* Suburban Realty Co. v. U.S., 615 F.2d 171 (5th Cir. 1980).

Dealer Factors

- Nature and purpose of the acquisition of the property
- Duration of ownership
- Efforts to sell the property
- **Number and substantiality of sales**
- **Extent of subdividing, developing and improving the property**
- Presence of a business office and advertising to achieve sales
- Time and effort devoted to sales activity

See U.S. v. Winthrop, 417 F.2d 905 (5th Cir. 1969).

Engaged in a “Trade or Business”

- Not defined by the IRC;
- Depends on the facts and circumstances of each case;
- TP may be engaged in more than one trade or business (e.g., a full-time lawyer who also flips houses also has a “dealer” trade or business on the side);
- Frequent and substantial sales and extent of development activity are most important factors.

Extent of Development Activity

- This is a very common question. How much can TP do to the property without becoming a dealer? Can the TP do the following:
  - Obtain zoning?
  - Procure site plans?
  - Grade the land?
  - Construct streets and utilities?
    - What if buyer requests streets as a condition to sale?
    - What if city requests streets as a condition to zoning?
- Note that soft costs generally are allowed without becoming a dealer. *See* Buono v. Comm'r, 74 T.C. 187 (1980) (subdivision approval efforts were "purely legal steps"). *But see* IRS Information Letter 2002-0013 (efforts to secure government entitlements are a dealer factor).
- Remember the 3 C's: "Can't Cut Curbs" (sometimes).

Held Primarily for Sale

- Three key factors:
  - Purpose for the acquisition of the property (e.g., purpose to hold for investment vs. purpose to sell to customers);
  - Extent of marketing/advertising activities (disposition via independent brokers bolsters investment motive);
  - Length of holding period (longer indicates investment intent).

Sale in the “Ordinary Course”

- Denotes a sale that is usual or expected, as opposed to sales that are abnormal or unexpected.
- Dealers may hold certain properties as investments and so sales of those properties would not be in the “ordinary course.”
  - Burden of proof is on the TP;
  - Use of separate entities is advised.

Example – Allen vs. U.S. (113 AFTR 2d 2014-2262)

- Allen bought raw land in 1987 with a purpose to develop it for sale;
- He developed engineering plans and multiple sets of plans for development;
- However, Allen lacked funds to actually develop the property himself;
- In 1998, Allen gave up and sold the property to another developer for a lump sum payment.

Allen, Cont'd

- Court held Allen was a dealer because:
  - He purchased the property with intent to develop it (even though he had no success actually developing it);
  - He created 10 different sets of development plans for the property.
- Allen's arguments that his intent changed failed due to lack of substantiation.

Allen, Cont'd

- Note the following investor factors:
  - This was Allen's only sale;
  - He held the property for 11 years;
  - He was employed as a full-time civil engineer during the entire 11 years;
  - No development actually occurred.
- The Allen case demonstrates the need for solid evidence, documentation and establishing clear facts and circumstances whenever a TP asserts that their intent with regard to a property changed from "intent to sell" to "intent to hold for investment." Must provide objective evidence.

Bramblett Structure

- Useful when investor holds appreciated property and wants to change intent and develop it for sale.
  - Note: Not needed if TP does not want to develop.
- Allows pre-development gain to be captured as long-term capital gain, with any additional "dealer" gain taken as ordinary income.
- 1031 Exchange implications too.
- *See* Bramblett v. Comm'r, 960 F.2d 526 (5th Cir. 1992).

Bramblett Example

- ABC, LLC (owned by A, B and C) owns raw land acquired 10 years ago for $1,000,000.
- The land has appreciated in value to $3,000,000, and ABC would like to develop it into 100 residential lots and sell the lots to home builders for $40,000 per lot ($4,000,000 total).
- If ABC undertakes no tax planning, and simply develops and sells the lots, the entire $3,000,000 gain (($40,000 x 100) - $1,000,000) will be ordinary.
- How can ABC achieve long-term capital gain?

Bramblett Example, Cont'd

- First, the owners of ABC (individuals A, B and C) form a new development entity ("ABC Development, Inc.") to develop the land.
  - ABC Development must be a corporation or S-corporation, not a partnership or LLC, or all gain will be ordinary. IRC 707(b)(2)(B).
- Second, ABC sells the land to ABC Development for $3,000,000 ($500,000 down and a note for $2,500,000 payable as lots are sold).
  - It is best to support the $3,000,000 with an independent appraisal.
  - The installment note must be bona fide and pay adequate stated interest; should have meaningful down payment.
- Third, ABC Development will subdivide the land and sell lots to home builders. ABC should undertake no development activity.

Bramblett Example, Cont'd

- Results:
  - ABC realizes gain of $2,000,000. This gain should be long-term capital gain to the members A, B and C.
  - ABC (and its members) generally recognize such gain on the installment method as payments are received.
  - ABC Development's initial tax basis in the land is $3,000,000. When ABC Development sells all 100 lots for $4,000,000, ABC Development will realize development gain of $1,000,000. This is ordinary income for A, B and C.

Bramblett Risks

- ABC must be an investor and not a dealer (look at the multi-factor test). Favorable factors:
  - ABC's formation documents show an intent to hold only for investment (and not for development);
  - The land is ABC's only asset (it is best to segregate investment assets from dealer assets in separate entities);
  - This is ABC's only sale (but see Allen case) and ABC performs no marketing or advertising;
  - ABC has no business office undertaking sale activity;
  - ABC has held the land for 10 years;
  - ABC undertakes no development activity (but see Allen).

Bramblett Risks, Cont'd

- ABC Development also must not be an "agent" for ABC. This is a facts and circumstances test.
  - Parties must carefully document the lack of agency relationship.
  - Sale price and note terms must be arm's-length (get an appraisal!).
- ABC and ABC Development must not be collapsed and treated as one entity for tax purposes under "substance over form" grounds. Recent cases reject this argument:
  - Bramblett;
  - Phalen v. Comm'r, T.C. Memo 2004-206.

Mitigating Bramblett Risks

- Presence of strong business purpose for separate development entity is extremely helpful. Business purposes include:
  - Liability protection and segregation;
  - Presence of different owners;
  - Minimize Texas franchise tax (but only if ABC is organized as a limited partnership and meets the "passive entity" test).
- Must also follow corporate formalities to avoid "veil-piercing" or alter ego arguments.

Bramblett – Practical Issues

- Multiple state transfer/deed taxes? N/A in Texas.
- Lender issues? Will lender allow subordinated related party installment note?
- Developer must be an S-corporation (limitations on owners and one-class of stock rule).
- Additional entities, planning and expense.
- Penalty protection and tax opinions/memos.

Key Takeaways:

- Segregate dealer and investor properties in separate entities (create multiple investor entities if multiple sales contemplated);
- Avoid all dealer activities in the entity that holds property for investment;
- If investment intent changes to development activity, utilize a Bramblett structure to maximize capital gain;
- Use arm's-length terms (obtain an appraisal) and document the business purpose;
- Act consistently in all documents and correspondence and financial/tax reports.

1031 Exchanges Involving Partnerships

Background

- **General Rule** – Gain or loss recognized upon a sale or exchange of property. § 1001.
  - Individuals: Current LTCG tax rate is 20.0%, plus possible 3.8% additional "NII" tax.
  - Corporations: 35%.
- **Exception** – Since 1924, no gain or loss recognized if disposition structured as a "1031 exchange" for "like kind" property.
- **Purpose** – Congress did not want to impose a tax on theoretical gain where taxpayer continued his investment in like kind property.

Key Elements of § 1031

- § 1031(a) provides: "No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment."
- 3 prongs of the general rule:
  - There must be an "exchange."
  - The exchanged properties must be "held for" productive use in trade or business or investment ("held for" test).
  - The exchanged properties must be of "like kind."

2-Party vs. 4-Party

- A 2-party exchange is the most classic form of a 1031 transaction (a simultaneous transfer).
  - Example: Bill owns Whiteacre valued at $100. Sam owns Blackacre valued at $100. Bill and Same exchange Whiteacre and Blackacre.
- Today, the more common form is a 4-party transaction among the taxpayer, a buyer, a seller, and a "qualified intermediary" who stands in the middle. This transaction may span up to 180 days.

Excluded Property

- **Key exclusions:** no stock, partnership interests, certificates of trust, or "dealer" property.
  - No partnership or LLC interests! [Be careful with tenancy-in-common interests.]
  - No buying and "flipping" inventory.
- Special rules for related parties (1031(f)).

“Boot” and Basis

- **Boot:** taxpayer allowed to receive cash “boot” in the exchange, but boot is taxable to the extent of gain realized.
  - Liability relief also considered boot, but may be offset by liabilities assumed in the exchange.
- Boot always recognized first without any basis offset.
- **Basis:** generally, basis in relinquished property rolls over into replacement property, with certain adjustments.

Meaning of "Exchange"

- Reciprocal transfer of property.
- Sale and immediate reinvestment of cash does not qualify – can't touch the cash!
- No requirement that exchange be simultaneous; forward and reverse exchanges are allowed (and are normal).
- Cannot start a 1031 exchange with a lease. *Pembroke v. Helvering,* 23 B.T.A. 1176 (1931) (99-year lease). However, a lessee position with more than 30 years remaining may be acquired as replacement property in a 1031 exchange.

Examples

- TP grants a 99-year lease of Blackacre to Tenant in exchange for the Tenant's promise to pay annual rent and to transfer to the TP a fee interest in Whiteacre. This is a lease, not an exchange, so the TP's receipt of Whiteacre is taxable as pre-paid rent.
- Taxpayer sells Relinquished Land for $100, and one minute later purchases Replacement Land for $100. This is a sale followed by a purchase, and does not qualify as a 1031 "exchange".

The “Held For” Requirement

- Both “relinquished property” and “replacement property” must be held for productive use in a trade or business or for investment.
- Intent determined at time of the exchange.
- Generally covers all property used in a trade or business and all property held for investment, but excludes dealer property (e.g. home lots) and personal use property (e.g. vacation homes, unless safe harbor met).

Satisfying the “Held For” Requirement

- Test is intent at the time of the exchange; prior bad intent may be converted to good.
- No bright line tests for holding period of relinquished or replacement property.
  - One year is a good rule of thumb; two years is more conservative.
- Same taxpayer must start and complete the 1031 exchange (discussed in greater detail later).

Meaning of “Like Kind” Real Property

- Broadly defined:
  - “The words ‘like kind’ have reference to the nature or character of the property and not to its grade or quality. . . . The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class.”
- Any real property usually qualifies.
- By statute, foreign and domestic properties are never of “like kind.”
- Disregarded entities are “disregarded” and so can be acquired or sold in a 1031 exchange if they own real property.

Examples of “Like Kind” Real Property

- A 25,000 acre farm for the Empire State Building;
- A 30-year+ lease of real property for a fee interest in real property;
- Perpetual water rights for an easement;
- Mineral properties for a hotel; and
- Working interests in two leases;

Typical Exchange Structures

- "Forward" Exchanges are products of IRC 1031(a)(3) and generally use a "Qualified Intermediary" (and sometimes a "qualified trust" or "qualified escrow").
- "Reverse" Exchanges have no Code authority and rely on safe harbor Rev. Proc. 2000-37, generally using an "Exchange Accommodation Titleholder" or EAT.
- 45-day "identification" and 180-day closing required.

Requirements for a Forward Exchange

- TP must identify the replacement property(ies) within 45 days after transfer of relinquished property.
- TP must acquire the replacement property(ies) by the earlier of (i) 180 days after transfer of relinquished property, or (ii) the due date (with extensions) for the TP's tax return for the year in which TP transferred the relinquished property. Generally, 180-day limit applies.
- TP must not be in actual or constructive receipt of cash during this time.
- These are hard deadlines.

“Identification” of Replacement Property

- Identification must be made in writing within the 45-day period.
- Identification is limited to:
  - 3 properties (without regard to the FMV) OR
  - Any number of properties so long as aggregate FMV does not exceed 200% of FMV of the relinquished property.
  - There is also safety valve 95% rule
- Must specifically identify replacement property.
- Replacement property must be “substantially the same property” as was identified.

The 4 Key Rules for Partnership Exchanges

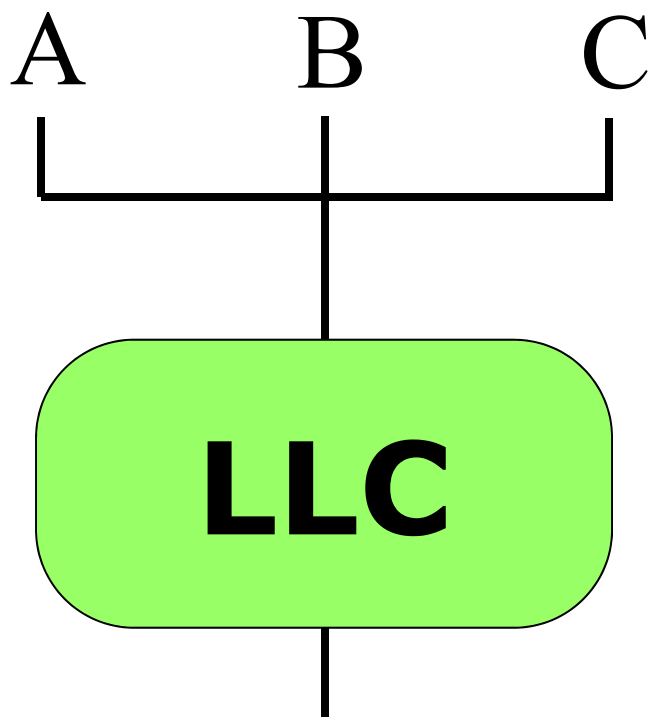
1. The same taxpayer that starts a 1031 Exchange must complete the 1031 Exchange.
2. Both the "relinquished" property and the "replacement" property must be "held for productive use in a trade or business or for investment." (the "Held For Test")
3. § 1031(a)(2)(D) prohibits 1031 Exchanges involving partnership interests. [TIC interests?]
4. "Substance over Form" and *Court Holding* doctrines apply.
   - *Court Holding*: Where corporation negotiated sale of property, subsequent liquidating distribution of property to shareholders followed by sale of property by shareholders to buyer was disregarded and treated as a sale of the property by the corporation to buyer followed by a liquidating distribution of cash.

The 4 Fact Patterns

1. Partnership distributes relinquished property to partner, who immediately sells and does a 1031 Exchange. **This happens frequently.**
2. Partnership does a 1031 Exchange, and immediately distributes replacement property to partner. **Sometimes.**
3. Partner contributes relinquished property to partnership, which immediately sells and does a 1031 Exchange. **Rare.**
4. Partner does 1031 Exchange, and immediately contributes replacement property to partnership. **Rare.**

***We are only discussing item 1 today.**

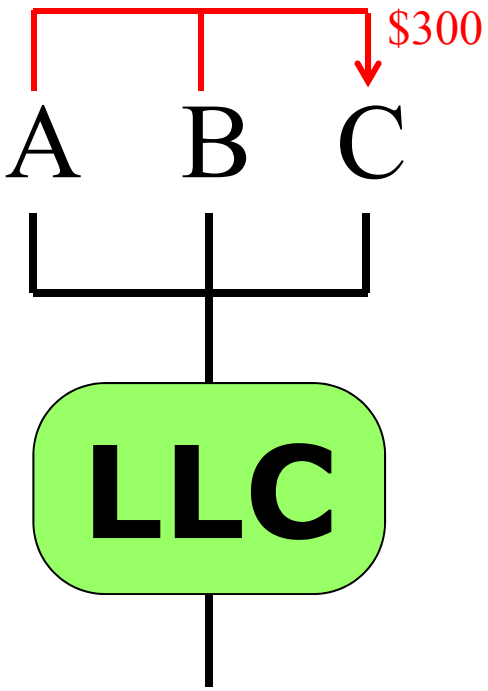
Basic Facts



*LLC receives an offer to purchase Parcel X for $900. A and B want to do a 1031; C wants to cash out or do a separate 1031.

Relinquished Real Property ("Parcel X")
(FMV $900; Basis $300; $0 Debt)

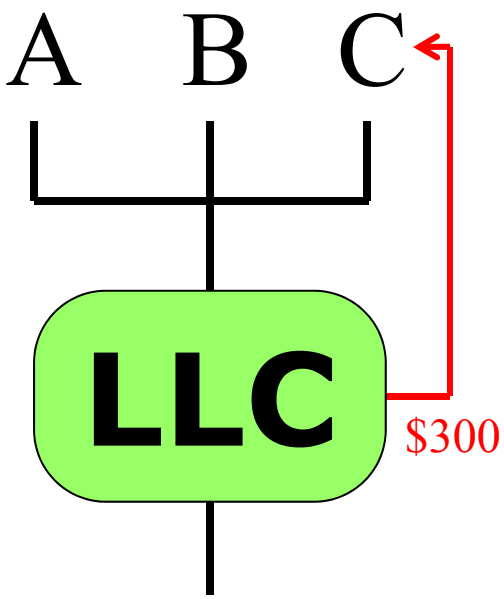
Situation 1 – "C" wants to Cash Out



Option No. 1 – A and B buy C's interest for Cash. Issues:

1. 754 election.
2. Do A and B have the cash?
3. LLC must acquire $900 of replacement property.

Situation 1 – "C" wants to Cash Out

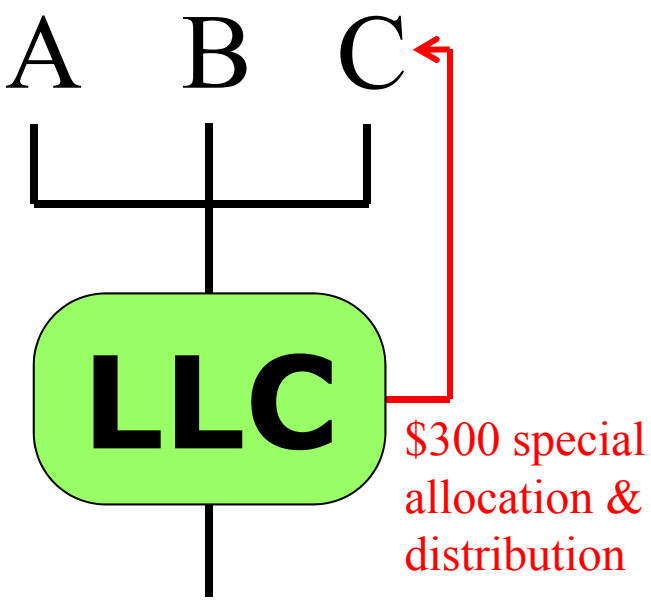


"Parcel X"
FMV $900
Basis $300
$0 Debt

Option No. 2 – LLC redeems C's interest for Cash. Issues:

1. 754 election.
2. Does LLC have the cash? Can LLC borrow $300 against Parcel X?
3. Need to acquire $900 of replacement property.
4. $300 mortgage boot if LLC borrows.
5. Risk that mortgage boot recast as disguised special allocation?

Situation 1 – "C" wants to Cash Out

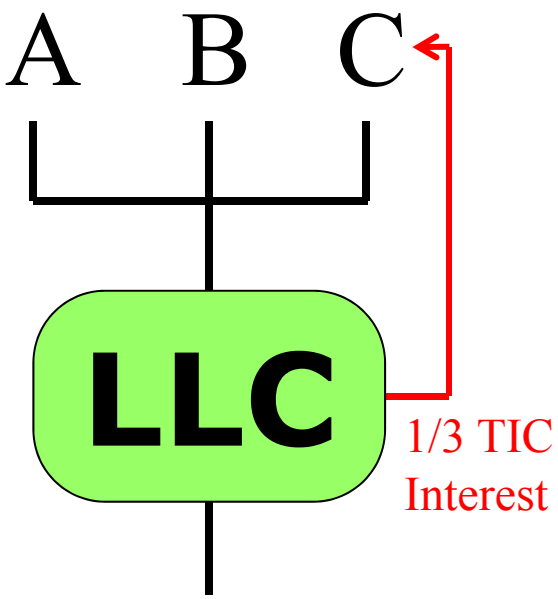


"Parcel X"
FMV $900
Basis $300
$0 Debt

Option No. 3 – LLC sells Parcel X to buyer for $900, deposits $600 with QI, and receives $300 at closing. LLC specially allocates entire $300 "boot" gain to C, and redeems C for $300 cash. Issues:

1. Must amend the LLC Agreement.
2. Will the special allocation be respected? Does it matter if C's capital account is either $100 or $0?
3. Recapture/1250 Gain first to C?
4. Need to acquire only $600 of replacement property.
5. Who bears risk if special allocation fails? A and B should seek indemnity from C.

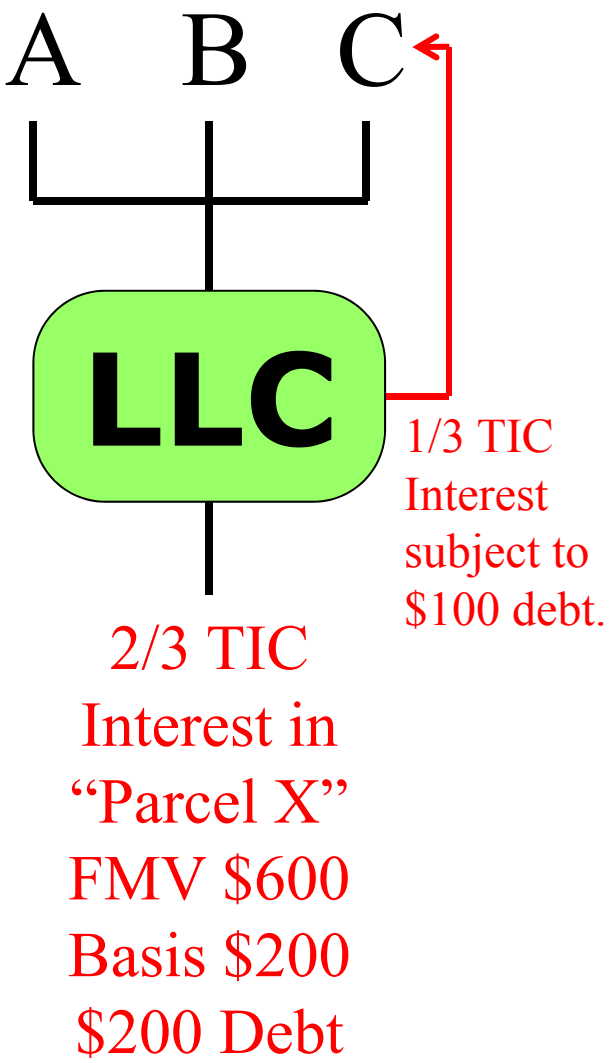
Situation 1 – "C" wants to Cash Out



Option No. 4A (most popular) – LLC redeems C for 1/3 TIC interest in Parcel X, leaving LLC as a 2/3 TIC. At closing, C and LLC sell the TIC interests to buyer. C keeps $300 cash; LLC deposits $600 with QI for a 1031 Exchange. Issues:

1. TIC arrangement respected? De facto partnership?
   - Reg. 1.761-1(a); *Powell*; Rev. Rul. 75-374; Rev. Proc. 2002-22 (technically does not apply).
   - Right of partition, no restriction on transfer.
2. Observe formalities: notify lenders; record deeds; sign TIC Agreement; assign utilities and contracts; C negotiates PSA and sells separately.
3. Timing of C's redemption? Before signing PSA with buyer? 1-day before closing? Risk of being recast as special allocation under *Court Holding? See also* Chase, 92 T.C. 874 (1989).
4. If respected, LLC must acquire only $600 of replacement property.
5. The buyer must consent. What if buyer does not consent?
6. Also used if A, B and C each want separate 1031s.

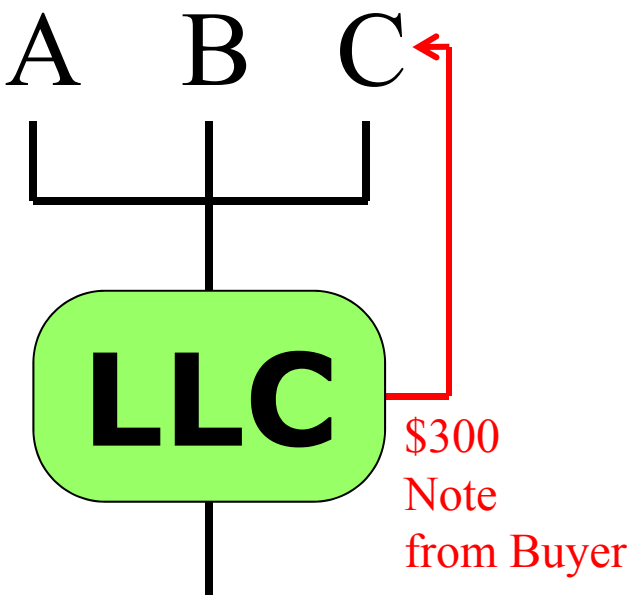
Situation 1 – "C" wants to Cash Out



Option No. 4B – Same as option 4A, but now Parcel X is subject to debt of $300. Additional Issues:

1. Due on sale clause?
2. Problems with syndicated lenders.
3. Default - - so what???
4. If this works, LLC must acquire $600 of replacement property, and must replace only $200 of debt (not full $300).

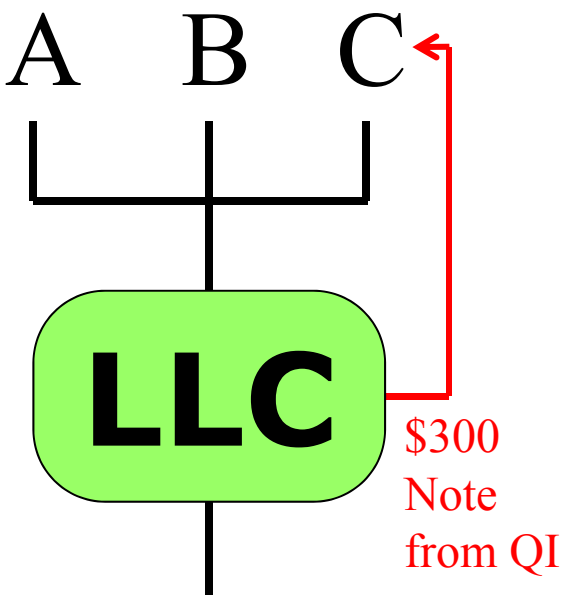
Situation 1 – "C" wants to Cash Out



Option No. 5A – LLC sells Parcel X to buyer for $900 ($600 cash to QI, and $300 installment note to LLC). Note is payable in two installments: [90/99%] payable [3/30] days after closing, with balance due on Jan. 2 of the following year. LLC distributes the note to C in complete redemption. Issues:

1. Installment obligation under § 453?
2. Tax issues with note distribution? 731 or 453?
3. Recapture/1250 Gain? Specially allocate to C? See § 453(i).
4. How soon to wait before distributing the note?
5. If respected, LLC must acquire only $600 of replacement property.
6. How to secure the buyer's note?

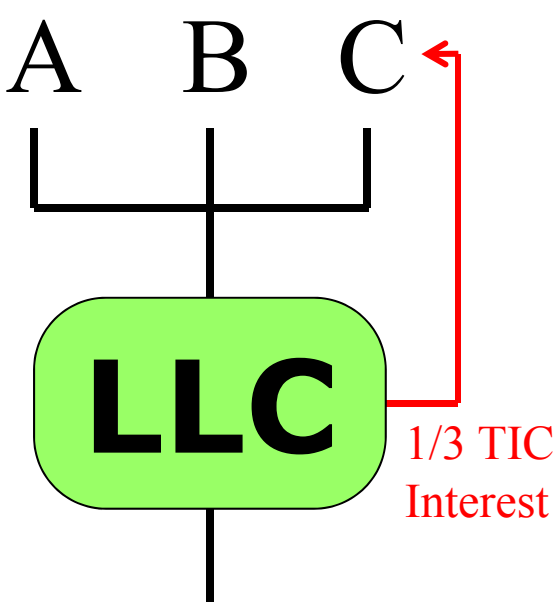
Situation 1 – "C" wants to Cash Out



Option No. 5B – Same as option 5A, but now assume that the buyer is not willing to issue the $300 note, so instead the QI issues its own note for $300 that LLC then distributes in redemption of C's interest. Issues:

1. Does the note qualify as an installment obligation under § 453?
2. How can the QI secure the note?
3. Issues with (g)(6) restrictions?
4. How to address in QI documents?
5. Note that this is a very efficient solution for last-minute deals.

Situation 2 – "C" wants to Exchange

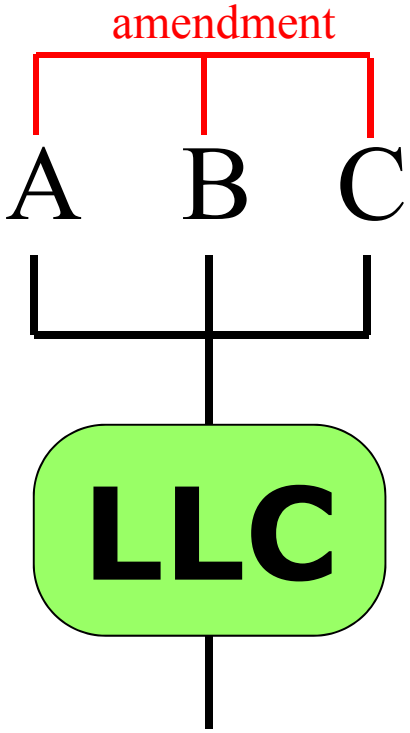


2/3 TIC Interest in "Parcel X" FMV $600 Basis $200 $0 Debt

Option No. 1 – LLC redeems C for 1/3 TIC interest in Parcel X, leaving LLC as a 2/3 TIC. At closing, C and LLC sell the TIC interests to buyer. C and LLC deposit $300 and $600, respectively, with QIs for 1031 Exchanges. Issues:

1. Same issues as on prior slides (TIC interests respected; observe formalities; redemption far in advance; potential lender issues).
2. Does C meet the Held For Test?
   - Helpful: *Magneson*, 753 F.2d 1490 (9th Cir. 1985); *Bolker*, 760 F.2d 1039 (9th Cir. 1985); *Mason*, TC Memo 1988-273; *Maloney*, 93 T.C. 89 (1989).
   - Problematic: Rev. Rul. 75-92; Rev. Rul. 77-337; Form 1065, Qs. 13 and 14; *Chase*, 92 T.C. 874 (1989).
3. Distribution far in advance is key (prior to negotiating PSA is preferable); otherwise, *Court Holding* and *Chase* cases may apply.
4. Viable option if A, B and C all want 1031s.

Situation 2 – "C" wants to Exchange



Option No. 2 – LLC sells Parcel X and deposits $900 with a QI. During the exchange period, LLC acquires property C on behalf of C for $300, and property AB on behalf of A and B for $600. A, B and C amend the LLC Agreement to provide for "tracking units" whereby 95% of the economics of property C go to C, and 95% of the economics of property AB go 50/50 to A and B. Issues:

1. Will the tracking allocations be respected? What if the percentages are 99% instead?
2. What result if C's exchange inadvertently failed, and LLC received $300 cash instead?
3. Can LLC redeem C's interest for 100% of property C? If so, how soon?
4. Another efficient solution for last-minute deals.