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REAL ESTATE SECURITIES

BY PETER M. FASS

Tenancies-in-Common Interests and §1031: Part 1

With this column, we begin a discussion of §1031 of the Internal Revenue Code (code) and its use in tenant-in-common (TIC) investments in real property. In the past several years, TIC real property investments have mushroomed in number and volume.

According to published information, the amount of equity raised in 2004 for TIC investments in real property totaled approximately $1.7 billion, which is more than double the 2003 total. These figures only include TIC properties being offered as privately offered securities. It is estimated that 2005's equity total could reach in excess of $4 billion. With leverage of up to 75 percent on top of the equity, the TIC business is a significant buyer of real property.[1]

One of the driving forces in the growth of the TIC business is illustrated by the following example from the recent NASD (National Association of Securities Dealers Inc.) Notice to Members 05-18, Private Placement of Tenants-in-Common Interests (notice).[2] Assume an investor purchased rental real property in 1972 for $200,000 and the property today has a fair market value (FMV) of $4 million. The sale of the property would cause the seller to incur taxes on the profit. If the owner of the rental property exchanged the rental property for different real property, he could defer paying these taxes. Because of the difficulty of finding equal and offsetting properties for each investor, the notice states that sponsors have offered interests in larger real estate offerings to pools of investors, in the form of TIC interests. In the example, rather than exchanging a rental property with an FMV at $4 million for a similarly valued property, the owner could pool his interest with other similarly situated property owners to acquire property or properties with a large enough value to provide tax deferral for all the investors.

§1031: General Rules

Code §1031 provides that the exchange of certain types of property will not result in the recognition of gain or loss. The property exchanged and received in the transaction must

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be of like-kind and must be held either for investment or for productive use in the taxpayer's trade or business; however, such property does not include stock in trade or other property held primarily for sale, partnership interests, stocks, bonds, notes, choses in action, certificates of trust or beneficial interests, and other securities or evidences of indebtedness or interest.[3] Section 1031 is not applicable to any exchange of partnership interests, regardless of whether the interest exchanged are general or limited interests, or are interests in the same or in different partnerships.[4]

• ***Gain Recognition.*** Gain is recognized in a transaction which otherwise qualifies under §1031 if, in addition to nonrecognition property, the taxpayer receives other property, so-called "boot." For example, if a taxpayer holding a parcel of land having a basis of $50,000 and an FMV of $100,000, exchanges the property for a parcel of land with an FMV of $90,000 plus $10,000 in cash, the taxpayer would recognize $10,000 of gain on the transaction. The remaining $40,000 of gain would be deferred until the taxpayer disposes of the second parcel in a taxable sale or exchange. No loss can be recognized in a qualifying like-kind exchange.

Gain realized on a §1031 exchange must be recognized to the extent that the gain is subject to the recapture provisions of §§1245 and 1250.[5] Generally, if no gain is recognized in a like-kind exchange, recapture of any depreciation deducted on the property transferred is deferred and is recaptured when the property received in the exchange is finally disposed of.[6] If the value of the depreciable property received is less than the depreciation subject to recapture, the excess is recaptured at the time of the exchange.

• ***Losses Not Recognized.*** Losses, as a general rule, are not recognized in a transaction that qualifies under §1031. However, if the taxpayer surrenders boot in addition to qualifying property, gain or loss is recognized on the boot surrendered. Although a liability of the transferor assumed by the transferee is deemed boot to the transferor, the regulations permit netting of boot given against such a liability.[7]

• ***Basis Rules.*** Section 1031 establishes certain basis rules: in general, the property received acquires the basis (and holding period) of the property surrendered: (i) reduced by any money received or liabilities assumed by the transferee to the exchange, and by any loss recognized to the transferor; and (ii) increased by the amount of gain recognized to the transferor. The basis as thus computed is allocated first to the "boot" property received to the extent of FMV, the remaining basis being allocated among the nonrecognition properties received, in proportion to relative FMV as of the date of the exchange.

Formulas

• ***Formula for Determining Basis of Properties Received***

Adjusted basis of qualifying (nonrecognition) property surrendered:

Adjusted basis of other (boot) property surrendered.

Aggregate basis of properties surrendered.

Add:

Cash surrendered and notes given.

Indebtedness attaching to property acquired

Gain recognized (includes gain recognized on qualifying property surrendered and boot property surrendered.)

Less:

Cash received.

Indebtedness attaching to property surrendered.

Loss recognized (loss only recognized on boot property surrendered, not on qualifying property surrendered) equals Aggregate basis of all properties received.

• ***Formula for Determining Basis of Nonrecognition Property Received***

Aggregate basis of all properties received.

Less:

FMV of other (boot) property received equals

Basis of nonrecognition property received (allocate on bases of relative FMV if more than one property received.)

The holding period of the transferred qualified property is tacked on to the received qualified property's holding period. IRC §1223(a). There is no tacking on any nonqualified property received in an exchange.

The example in Table 1 illustrates a typical two-party simultaneous §1031(a) exchange. T surrenders a building (with an adjusted basis of $2 million and an FMV of $8 million, subject to a mortgage of $3 million), in exchange for a building (with an FMV of $8 million, subject to a mortgage of $4 million) and marketable securities with an FMV of $1 million.

Table 1

1. Computation of Realized Gain	
FMV of nonrecognition property received	$8,000,000
FMV of boot property received	$1,000,000
Indebtedness attaching to property transferred	$3,000,000
Total consideration received	$12,000,000
Less:	
Adjusted basis of property surrendered	$2,000,000
Indebtedness attaching to property received	$4,000,000
Gain realized	$6,000,000
2. Computation of Boot Received	
Indebtedness attaching to property surrendered	$3,000,000
Less:	
Indebtedness attaching to property received	$4,000,000
Boot received against which netting permitted	- 0 -
FMV of boot property received	$1,000,000
Boot received	$1,000,000
3. Computation of Gain Recognized	
Gain recognized (lesser of gain realized or boot received)	$1,000,000
4. Computation of Basis of Properties Received	
Adjusted basis of nonrecognition property surrendered	$2,000,000
Aggregate basis of properties surrendered	$2,000,000
Add:	
Indebtedness attaching to property acquired	$4,000,000
Gain Recognized	$1,000,000
	$7,000,000
Less:	
Indebtedness attaching to property surrendered	($3,000,000)
Aggregate basis of all properties received	$4,000,000
5. Computation of Basis of Nonrecognition Property Received	
Aggregate basis of all property received	$4,000,000
Less:	
FMV of boot property received	($1,000,000)
Basis of nonrecognition property received	$3,000,000

Source: Peter M. Fass

Boot

• ***Boot.*** If cash or other nonqualifying property—"boot"—is received in what is otherwise a like-kind exchange, the realized gain is recognized, but only as to the cash plus the FMV of the nonqualifying property. But if boot is received and a loss incurred on the qualified property being transferred, the loss is not recognized.

If the value of the qualified property and boot received is less than the realized gain on the property transferred, the recognized gain cannot exceed the value of the boot received.[8] But if more boot is received than realized gain, the entire realized gain is recognized. The basis of the property received equals the basis of the property transferred, reduced by the cash received and increased by the gain recognized.

Example: T transfers vacant land held for investment to X. T brought the land for $150,000. X gives T $70,000 in cash and vacant land with an FMV of $90,000. T has a realized gain of $10,000 all of which is recognized since the boot ($70,000 of cash) received is more than the realized gain ($160,000-$150,000). T's basis in the received vacant land is $90,000, computed in Table 2:

Table 2

Basis of vacant land exchanged	$150,000
Less: Cash received	70,000
	$80,000
Plus: Gain recognized	10,000
Basis of vacant land received	$90,000

Source: Peter M. Fass

• ***Treatment of Liabilities.*** When mortgaged property is exchanged, the amount of the mortgage assumed by the transferee (or if the transferor was not personally liable, the amount of the mortgage to which the property is subject) is treated as cash that was received.[9]

Example. T transfers property with an adjusted basis of $2 million and receives $500,000 in cash and like-kind property with an FMV of $3.5 million. The property T transfers is subject to a $1 million mortgage. The boot equals $1.5 million ($500,000 in cash plus the $1 million mortgage).

To calculate the amount of cash received when both properties in the exchange are mortgaged, you net the mortgage on the property received against the mortgage on the transferred property. Only the excess of the mortgage transferred over the mortgage received is treated as boot.[10]

Example. T transfers property with an adjusted basis of $2 million and receives $500,000 in cash and like-kind property with an FMV of $3.5 million. The transferred property has a $1 million mortgage and the property received is subject to an $800,000 mortgage. The boot is $700,000 ($500,000 in cash, plus the $1 million mortgage less the $800,000 mortgage).

Example. Assume T transfers property with an adjusted basis of $2 million and pays $500,000 in cash for like-kind property with an FMV of $3.5 million. The transferred property is subject to a $1 million mortgage and the property received is subject to a $400,000 mortgage. The boot received by T is $100,000 ($1 million transferred mortgage, less the $400,000 mortgage on the property received, less the $500,000 cash paid).

Generally, if mortgaged property is transferred in return for cash and property subject to a mortgage that is greater than the one transferred the cash received cannot be offset by the excess of the mortgage assumed.[11]

Example. T transfers property with a $2 million adjusted basis and receives $500,000 in cash and like-kind property with a $3.5 million FMV. The transferred property is subject to a $600,000 mortgage, and the property received is subject to a $900,000 mortgage. The boot is $500,000.

Closing and brokerage fees paid in an exchange is treated as cash paid which reduces any boot received.[12]

The Future

The next column will continue the discussion of the general rules of §1031 including pre- and post-exchange refinancings of debt on exchanged property, the holding period of real property before the exchange related party exchanges, and multiparty exchange.

1. See generally, Napoli, TIC Business Booms (Real Estate Forum, February 2005) at 33-44.
2. NASD Notice to Members 05-18 (March 2, 2005) available at NASDR.com under Notices to Members.
3. IRC §1031 has been in the code since 1921, originally §202 of the code.
4. Reg. §1.1031(a)-1(a)(1).
5. See, IRC §§1245(b)(4) and 1250(d)(4).
6. Reg. §1.1031(d)-1(b), Example.
7. See, Reg. §1.1031(b)-1(c).
8. Reg. §1.1031(b)-1(a).
9. Reg. §1.1031(b)-1(c).
10. Reg. §1.1031(b)-1(c). Note that the excess of mortgage transferred over the mortgage received is reduced by any cash paid. Reg. §1.1031(d)(2), Example 2(c).
11. Reg. §1.1031(d)(2), Example 2(c).
12. Rev. Rul. 72-456, 1972-2 C.B. 468.