



Special issues for multifamily owners in a 1031 exchange - by Pamela Michaels

July 02, 2019 - Front Section

In the Northeast and New York City, the multifamily market is hot, hot, hot. Sellers of multifamily properties are receiving strong offers and selling properties for significant amounts. Overall, this is great news for multifamily owners. However, along with a sale, often come significant capital gain taxes on disposition. Section 1031 exchanges provide a powerful tax deferral solution for multifamily owners to defer paying these capital gain taxes otherwise due after disposition. Multifamily owners should be aware they may be faced with special challenges and unique 1031 exchange issues. In order to best structure and proceed with the exchange, such owners should become familiar with these issues. Some of these special issues are outlined below:

Identifying the Tax Owner

Many multifamily owners own property in single member LLCs that are disregarded for federal tax purposes. These entities are generally set up and named to reflect the address of the property owned for practical reasons. For example, a multifamily apartment building located at 695 East 21st St., New York, N.Y. (which would technically be located in the east river!) might be titled in the name of 695 East 21, LLC. While 695 East 21, LLC is on title to the property, the filer of the tax returns for the LLC (and the tax owner) will likely be the sole member which itself could be multi-member LLC. Let's say such multi-member LLC is titled 695 East 21st Street Associates, a New York partnership. For purposes of a 1031 exchange, the tax owner of the property, 695 East 21st Street Associates, LLC, is the exchanging entity and all documents will be drawn in the name of the exchanging entity. Remember this when I address title to replacement property below.

Ownership Structure

695 East 21st Street Associates, LLC is the exchanging entity. 695 East 21st Street Associates, LLC would like to sell the property after 20 years of ownership and perform a 1031 exchange. The entity has over 20 partners in its partnership. The partnership has signed a contract to sell the property for \$50 million. While preparing for closing, the partnership is advised that partners owning approximately \$5 million of the property wish to cash out and not be included in the 1031 exchange. How can payment of such \$5 million be accomplished without interfering with the 1031 exchange? There are several options that may be available to the partnership, the discussion of which is beyond the scope of this article and must be reviewed with the exchanger's legal and tax advisors. Examples of such options include:

- A. Use of funds not from the proceeds of the sale to redeem such partners' interests, including funds raised from new investors;
- B. Use of proceeds from the sale to redeem the interests of liquidating partners resulting in the partnership performing a partial, as opposed to full, exchange;
- C. Using a partnership installment note to pay liquidating investors what is due to them; and
- D. Performing a partial drop down to liquidating investors of their interests in the property.

All of these options may involve risks which must be discussed with the partnership's tax advisors preferably well in advance of signing any contract but definitely in advance of closing.

Avoiding Boot

When a multifamily property is sold, typically certain amounts are credited against the purchase price. Examples are security deposits, pre-paid rents and repair costs. However, doing so in a 1031 exchange could generate boot as the seller has, in effect, treated the security deposits as part of the buyer's consideration for the property. At closing, this cash is in the seller's hands and does not pass to seller's qualified intermediary to be used in the exchange. This is boot, plain and simple. That result could be avoided by having the seller bring such security deposits to closing or by the seller paying the deposits to the buyer outside of closing. The same rationale applies to other prorated items credited to buyer at closing in the purchase and sale agreement, such as a buyer credit for repairs. In the latter case, a seller may prefer to reduce the purchase price for the property to reflect the cost of the repair. The characterization of exchange expenses and closing costs in an exchange is a complex area and should be analyzed by a qualified tax professional before closing to avoid potential boot.

Title to Replacement Property

Once the sale of relinquished property has occurred, the exchanger has specific time periods in which to acquire all replacement property. Contracts for replacement property will only qualify if the buyer is the same tax owner as that selling the relinquished property. Using the example set forth above, this does not mean that the replacement property contract buyer must be 625 East 21st Associates, LLC, but only that the tax owner of whoever is named as the buyer be 625 East 21st Associates, LLC. Thus the exchanger is free to form a single member LLC named again after the property address to acquire and take title to the replacement property as long as it is disregarded and its sole member is 625 East 21st Associates, LLC. There are other forms of disregarded entities but the single member disregarded LLC is the one most commonly used.

Pamela Michaels, Esq., is sr. vice president with Asset Preservation, Inc., New York, N.Y.

New York Real Estate Journal - 17 Accord Park Drive #207, Norwell MA 02061 - (781) 878-4540