POPULAR TRANSACTIONS IN THE REAL ESTATE INDUSTRY

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A review of Section 1031, tenants-in-common, and entity reorganizations in the current tax landscape.

Real estate owners, investors, and developers are inevitably faced with the same situation. At some point, they will wish to sell their property. Further, they will want to do so with a minimal tax impact. Whether Section 1031 like-kind exchanges (Section 1031 exchange), tenant-in-common arrangements (TICs), or entity reorganizations, the current landscape of real estate taxation provides a variety of tax strategies to explore when considering transactions.

Section 1031 Like-kind Exchanges

While the availability of Section 1031 exchanges has been narrowed in recent years, the theory behind them has remained the same. Taxpayers swapping solely like-kind real property generally will be able to do so without recognizing a capital gain. In essence, the exchange of qualifying real estate of an equivalent nature can be a non-taxable event given the right circumstances. The ability to benefit from Section 1031 is further limited, however, by the technical requirements of the Section: "No gain or loss shall be recognized on the exchange of real property held for productive use in a trade or business or for investment if such real property is exchanged solely for real property of like kind which is to be held either for productive use in a trade or business or for investment."[1]

Therefore, the fundamental characteristic of a Section 1031 exchange under current law is the involvement of real property. Historically, tangible personal property also qualified, ultimately allowing swaps for example of vehicles or heavy machinery used in businesses. The Tax Cuts and Jobs Act excluded these types of transactions, and instead gave Section 1031 non-recognition treatment exclusively applicable to real property. This begs the question: what is considered real property for Section 1031 exchanges? Treas. Reg. 1.1031(a)-3(a)(1) defines real property to include "land and improvements to land, unsev-

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ered natural products of land, and water and air space superjacent to land." Taxpayers are likely familiar with classifying pavement or landscaping as land improvements. In this case, improvements to land also include buildings, parking garages, or fences—all of which can be classified as "inherently permanent structures." If the property is affixed permanently to the land, then it generally qualifies for a Section 1031 exchange. Even the definition of "affixed" is discussed in the Regulations, with considerations such as "the damage that removal of the distinct asset would cause to the item itself or the real property to which it is affixed,"[2] or "the time and expense required to move the distinct asset"[3] playing a part in defining what would qualify for a Section 1031 exchange.

Taking this a step further, structural components of these inherently permanent assets owned by the taxpayer would also be included in like-kind exchanges. Although not strikingly similar to a structural component of a building, resources such as crops, timber, or even water are considered real property if these assets qualify as "unserved natural products of land."[4] Even intangible assets can be classified as real property for these purposes. An easement or option to acquire real property may be able to be swapped tax-free under Section 1031. What does not qualify, however, is "real property held primarily for sale."[5] Therefore, dealers of land who hold tracts of land for sale to buyers would not be able to exchange their land for another parcel of land under this Section.

While the type of property is crucial to qualifying for a Section 1031 exchange, the quality or "grade" of improvement is not. Essentially, the "class" of property is the determining factor of qualification, not the level of improvement.[6] Bottom line, regardless of whether land parcels are located in the suburbs, country, or city, taxpayers may be able to swap these properties for the other tax-free. *William P. Adams* is a good example of this rule.[7] In this case, Adams exchanged a rental home in San Francisco for a rental home in Eureka, California. The Eureka house was described as "old, dilapidated, and moldy," but due to its larger size, Adams found it a prudent investment. In the end, Adams had to only pay tax on the "boot" (cash or property included in the exchange, other than the qualified real property being exchanged) involved in the transaction. The characteristics or location of the homes played no factor in the deferral of gain relative to the real property under question.

Public accounting firms and consulting firms have developed entire practices around cost segregations. The benefit of cost segregation studies is to identify property eligible for accelerated depreciation, most notably bonus depreciation. One of the requirements for property to be bonus-eligible is that the property has a MACRS recovery period of 20 years or less, which by nature excludes commercial buildings with 39-year lives or residential rental property with 27.5-year lives. Assets that are bonus eligible include 15-year land or qualified improvement property or 5-year fixtures. Under state or local law, most of the time these types of affixed properties would be considered real property.[8] Therefore, the property having been eligible for bonus depreciation or the presence of "cost segregation" property in the transferred or received property does not in itself determine whether property can be swapped tax-free or not. The length of the depreciable life of cost segregation property also does not solely determine availability for a Section 1031 exchange—again, under state and local law this property may be considered real property. That being said, taxpayers should be aware that ordinary income recapture may apply when dealing with Section 1245 property if, for example, the value of relinquished Section 1245 cost segregation property exceeds the value of replacement Section 1245 property.[9]

An interesting caveat surrounds "incidental property" when complying with the specific requirements of properly identifying replacement property. Treas. Reg. 1.1031(k)-1(c)(5) provides guidance on both the definition of incidental property and a threshold for fair market value to be considered within this definition. It states that "property is incidental to a larger item of property if (A) In standard commercial transactions, the property is typically transferred together with the larger item of property, and (B) The aggregate fair market value of all of the incidental property does not exceed 15% of the aggregate fair market value of the larger item of property." For example, if an apartment building is being transferred, typically expected items of incidental property would be furniture or laundry machines.[10] Therefore, in connection with meeting the requirements for replacement property identification, assuming the 15% fair market value test is met, taxpayers generally don't need to include descriptions of these incidental properties when identifying the larger property.

If all requirements are met, real property (including Section 1245 and Section 1250 property) held for business or investment swapped for like-kind property will generally qualify for a Section 1031 exchange. The type of taxpayer—individual, corporation, or partnership—is of no importance. Related parties, however, are subject to a unique restriction for gain nonrecognition. Section 1031(f)(1) states that Section 1031 exchanges between related parties can be a nonrecognition event (barring boot, etc.) as long as within a two year period after the original transfer neither the related transferee nor the related transferor disposes of the exchanged property. Related parties for this purpose are the same as those described in Section 267(b) or Section 707(b)(1), including, among others, siblings, spouses, lineal descendants, or a grantor and a fiduciary of any trust. Therefore, Section 1031 exchanges require some foresight and continued communication between related parties to ensure the "two-year rule" is not breached. Taxpayers have historically attempted to structure transactions to avoid this two-year rule; an initial exchange would be made between unrelated parties, and then the transferee would further exchange property with a party related to the original transferor within a two-year period. Taxpayers should be aware of the risk that structuring Section 1031 exchanges to avoid the two-year rule could result in taxable treatment upon review by the IRS.

Deferred Exchanges

While Section 1031 exchanges at times occur simultaneously, there is often a delay between the transfer of one property and the receipt of the other. These delayed exchanges are known as "deferred exchanges," and subject to fulfilling certain requirements, they too can be nonrecognition events. Nonrecognition for deferred exchanges was established by *Starker*.[11] In this case, the land exchange agreement was between the Starkers and Crown Zellerbach Corporation (Crown). In exchange for timberland acreage, Crown had promised to provide replacement property "within five years or pay any outstanding balance in cash." Although the rules involving a deferred Section 1031 exchange are now different than the agreement in *Starker*, the foundation of the current law was set.

Instead of the five-year identification period discussed in *Starker*, the current law requires that any replacement property be both identified within 45 days and acquired before the earlier of:

1. 180 days after the transfer of the relinquished property, and
2. the due date (with consideration of extensions) of the tax return for the year the transfer occurs.[12]

In other words, any replacement property must be identified within the "identification period" and received within the "exchange period." There are two ways to satisfy the 45-day identification requirement when identifying multiple properties:

1. identify three properties without regard to the fair market values of the properties (the three-property rule), or
2. any number of properties as long as their aggregate fair market value as of the end of the identification period does not exceed 200% of the aggregate fair market value of all the relinquished properties as of the date the relinquished properties were transferred by the taxpayer (the 200% rule).[13]

Essentially, the three-property rule allows the taxpayer to identify properties with a higher fair market value, but the 200% rule allows for the taxpayer to identify a greater number of properties at a potentially lower fair market value in total. An exception to the general rule is made available by Treas. Reg. 1.1031(k)-1(c)(4)(ii). Taxpayers can identify more than 200% of the aggregate fair market value of relinquished properties as long as, by the end of the exchange period, the taxpayer ends up receiving replacement property that is at least 95% of the aggregate fair market value of all identified replacement properties.[14]

1 I.R.C. Section 1031(a)(1).
2 I.R.C. Section 1.1031(a)-3(a)(2)(ii)(C)(3).
3 I.R.C. Section 1.1031(a)-3(a)(2)(ii)(C)(5).
4 I.R.C. Section 1.1031(a)-3(a)(1).
5 I.R.C. Section 1031(a)(2).
6 I.R.C. Section 1.1031(a)-1(b).
7 TC Memo 2013 -7.
8 *Smalley*, 116 TC 450 (2001).
9 Levun and Cohen. 2021. Reference Book for the Thirty-Fifth Annual Partnership, LLC & S Corporation Tax Planning Forum and Twenty-Sixth Annual "Fundamentals of Flow-Through" Partnership, LLC & S-Corporation Tax Seminar, pg. 389.
10 Treas. Reg. 1.1031(k)-1(c)(5)(ii), Ex 2.
11 602 F.2d 1341 (August 24, 1979).
12 I.R.C. Section 1031(a)(3).
13 I.R.C. Section 1.1031(k)-1(c)(4).
14 Treas. Reg. 1.1031(k)-1(c)(4)(ii).
15 Treas. Reg. 1.1031(k)-1(c)(4)(i).
16 Rev. Proc. 2000-37, 2000-2 CB 308, 9/18/2000.
17 Rev. Proc. 2000-37, 2000-2 CB 308, 9/18/2000.
18 Rev. Proc. 2000-37, 2000-2 CB 308, 9/18/2000.
19 *Barker*, 74 T.C. 555, 563-564.
20 74 TC 653 (1980).
21 324 U.S. 331 (1945).

Further, "any replacement property received by the taxpayer before the end of the identification period"[15] would also qualify for this exception.

Even if all of these requirements are met, a Section 1031 exchange may have some or all of any gain recognized if the taxpayer actually or constructively receives non-qualified property. This extraneous property is colloquially referred to as "boot." Boot can consist of cash or other property that is not like-kind. Further, debt relinquished (netted with debt assumed) is considered cash exchanged outside of the qualified property. Whether nonrecourse or recourse, debt assumed is included in the exchange as boot under Section 357(d). In order to actually or constructively receive boot, the taxpayer must be in control of the property. Essentially, whether the taxpayer has the property in hand or easily has access to the property, actual or constructive receipt has respectively occurred. If the boot is received prior to the completion of the Section 1031 exchange it could require the transaction involving the relinquished property to be treated as a sale. If the boot is not received in advance of the completion of the Section 1031 exchange, the gain recognized is generally limited to the sum of the cash and the fair market value of any non-qualified property received. This limitation applies whether the Section 1031 exchange is a simultaneous or deferred exchange.

Considering the stakes involved with constructive receipt of boot, four safe harbors have been established to avoid such a situation:

1. security or guarantee arrangements,
2. qualified escrow accounts and qualified trusts,
3. qualified intermediaries, and
4. interest and growth factors.

While all four are undoubtedly utilized, arguably the most common tactic is the use of a qualified intermediary (QI). Ultimately, a QI is an individual that either actually or constructively receives cash or other property in the taxpayer's place. Considering QIs control assets related to the transaction, they cannot be an agent (accountant, attorney, employee, related party, etc.) of the taxpayer. By using a QI to facilitate the deferred transaction until the replacement property is transferred, the transaction can maintain the designation of a Section 1031 exchange.

Section 1031 E xchanges- Further Types

At face value, as discussed up to this point, Section 1031 exchanges are seemingly straightforward. These transactions become more complicated in practice. Following the initial introduction of Section 1031 exchanges, variants of the basic simultaneous and deferred tax-free exchanges emerged: reverse Section 1031 exchanges, three party like-kind exchanges, build-to-suit exchanges, and straw man exchanges. Traditionally, and when the transaction does not involve a simultaneous exchange of properties, the transferor relinquishes their property and then identifies replacement property within the 45-day identification period. A reverse exchange is done in the opposite order. In this type of transaction, the replacement property is acquired prior to the sale of the transferor's original property (relinquished property). This replacement property is treated similarly to the boot discussed above in a forward exchange with regard to constructive receipt. A qualified exchange accommodation arrangement (QEAA) must be utilized to avoid constructive receipt—otherwise, the property is deemed to be received prior to the completion of the exchange thus disqualifying it from being able to be used in a Section 1031 exchange.

In essence, the exchange accommodation titleholder (EAT), the facilitator of these transactions, becomes the owner of the replacement property. An EAT is someone "who is not the taxpayer or a disqualified person and either such person is subject to federal income tax or, if such person is treated as a partnership or S corporation for federal income tax purposes, more than 90% of its interests or stock are owned by partners or shareholders who are subject to federal income tax."[16] Essentially, an EAT is a person or flow-through entity that legally owns the property. There must be a written, formal agreement entered into within five days of the transfer of the replacement property between the EAT and taxpayer, outlining the QEAA. From there, the 45-day identification period applies in reverse: 45 days from the EAT's receipt of the replacement property, the taxpayer must identify a property to relinquish in the reverse Section 1031 exchange. The 180-day period also applies to the amount of time a QEAA holds the properties in question: "The combined time period that the relinquished property and the replacement property are held in a QEAA does not exceed 180 days."[17]

Mechanically, considering the EAT legally holds ownership of the property, it is also required to pay expenses related to the property. Interestingly, the taxpayer can still lease the replacement property from the EAT during this 180-day period, which might in effect fund the responsibility of the EAT to pay the tax, insurance, and other expenses. The taxpayer can, therefore "manage the property, supervise improvement of the property, act as a contractor, or otherwise provide services to the exchange accommodation titleholder with respect to the property."[18] Further, even though the EAT has temporary ownership, they may not have to put up their own funds for the purchase of the replacement property. Instead, the taxpayer can loan the EAT the amount necessary to acquire the replacement property, and then the EAT in turn can issue a note to document the loan to the taxpayer. In addition, the taxpayer can guarantee a bank loan for the EAT. Once the relinquished property is sold by the EAT, and the Section 1031 exchange is carried out, the cash received in the sale of the relinquished property is used to repay this note and satisfy the debt.

Another interesting Section 1031 exchange structure surrounds the involvement of a third party. If the buyer of the taxpayer's property does not have a property to exchange, a third party can sell the buyer their own property. Then the buyer exchanges this recently purchased property to the taxpayer as replacement property fulfilling the Section 1031 requirements for the taxpayer but not the buyer. Rev. Rul. 77-297, 1977-2 CB 304 explores an example of this structure. In the Revenue Ruling, the business property the taxpayer was selling was a ranch. The ranch sale agreement was contingent upon the buyer's purchase of a replacement property. In this example, the buyer was successful in purchasing a ranch as replacement property, which in turn gave the taxpayer/transferor nonrecognition treatment in the swap. The buyer, however, did not have the advantage of nonrecognition treatment because in their hands the replacement property was not held for use in a trade or business or as an investment prior to selling it to the taxpayer (as required in Section 1031(a)(1)).

There are even court cases that have allowed "four-party" Section 1031 exchanges as nonrecognition events. In these situations, the buyer does not wish to own the replacement property nor be a party involved in the Section 1031 exchange directly. In this case, a fourth party (using the funds from the buyer) takes ownership of the replacement property from the identified third-party seller and carries out the exchange in the buyer's stead. Essentially, this fourth party acts as a qualified intermediary. To clarify, the four parties are:

1. the taxpayer/transferor,
2. the third-party seller of the replacement property,
3. fourth party facilitator/QI, and
4. the buyer of the relinquished property.

Barker cautions taxpayers from adding too many layers and parties into the transaction. The case indicates that while four parties can result in nonrecognition treatment, "at some point the confluence of some sufficient number of deviations will bring about a taxable result."[19]

In all previous discussions, replacement property has been completed and constructed property. It is sometimes possible for taxpayers involved in constructing property to be eligible for Section 1031 exchanges as well. In a "strawman" exchange, the taxpayer can effectively construct or renovate the replacement property themselves. In order to do so, they would need to locate a "straw man" contractor that would be willing to temporarily own and construct the property prior to the Section 1031 exchange. In this way, the taxpayer does not have legal title nor beneficial ownership of the replacement property but can have some control over the development of the property via the unrelated "straw man" party. Construction or renovation occurs prior to the "sale" of the relinquished party to a buying party, and the construction period is not considered when calculating the 180-day identification period.

The straw man transaction is clearly dependent on finding an unrelated contractor willing to own and construct the property prior to being paid for their work. As a result, taxpayers should consider the risk involved in this strategy, along with the complexity that is inherent when depending on a third party in such a way. Overall, taxpayers have options with regard to structuring Section 1031 exchanges and should be aware of these prior to executing the transactions themselves.

Tenancy in Common (TICs)

Instead of forming a partnership entity, taxpayers often form TICs instead. TICs allow for two or more parties to own a fractional interest in a rental or investment property themselves, without having a partnership entity (of which they are partners) own the property. Treas. Reg. 301.7701-1(a)(2) guides that the level of activity within the TIC is limited to the service of the property as rental or investment property only. For example, repairs would be allowable within this structure, but not services to the tenants. This is an important distinction, as in the current market many apartment complexes and landlords are expected to provide services outside of the bare minimum. Given the relative vagueness of this guidance as to what level of activity would require partnership versus TIC treatment, Rev. Proc. 2002-22 was issued. In this Rev. Proc., fifteen safe harbors are outlined to specify the requirements of a TIC. A few of the more interesting being:

1. Number of co-owners: 35 owner limitation.
2. No treatment of co-ownership as an entity: There should be no entity income tax return, partnership operating agreement, etc.
3. Voting: Co-owners must unanimously approve certain aspects of the co-ownership and property. For example, the hiring of a manager would require such approval.
4. Restrictions on alienation: Owners must be able to sell their interest in the property without the approval of other owners.
5. No business activities: "The co-owners' activities must be limited to those customarily performed in connection with the maintenance and repair of rental real property (customary activities). See Rev. Rul. 75-374, 1975-2 C.B. 261."

If the parties operate within these requirements, they can make the Section 761(a) election establishing the arrangement as a TIC rather than a partnership. Functionally, the allocation of ownership and expenses may work similarly for TICs and partnerships—they are generally based on the percentage of ownership. While partnership arrangements can provide both liability protection and more flexibility when it comes to income or loss allocations many taxpayers opt for TICs for simplicity and lack of administrative burden in filing a Form 1065 or forming a partnership entity.

Another potential benefit of a TIC is the capability to complete a Section 1031 exchange within this structure. As discussed previously, Section 1031 exchanges cannot occur if exchanging property other than real property—thereby excluding a swap of a partnership interest (even if the partnership holds real property within the entity). However, considering a TIC is by definition an interest in real property rather than a business, TIC interests can qualify for nonrecognition treatment as a Section 1031 exchange. It is important to note that these swaps can occur outside of any approval from the other tenants in common—in effect, the taxpayer can exchange their portion of the property as though it were a separate asset altogether. Partnerships themselves can hold a TIC interest in rental property. As a result, assuming the partnership entity does not participate in an activity disqualifying the TIC arrangement, a partnership can exchange real property tax-free via the TIC.

At times, partners within a partnership may have differing objectives, and timelines, with respect to their investment in the partnership's real property. Accordingly, the partners may want to deal with the disposal of a property held within the partnership in different ways. Some partners may want to retain ownership in the property, some may want to sell the property for cash, and some may want to exchange it for another property. In these situations, some taxpayers have utilized a "drop and swap" transaction to resolve differences in investment objectives. However, utilizing this type of transaction is not without risk for reasons discussed later in this article. In this type of transaction the rental or investment property is distributed from the partnership to its partners. In order to distribute one piece of property to multiple partners, the partnership distributes TIC interests in the property. From there, the partners are free to keep their interest, sell it in a taxable exchange, or complete a Section 1031 exchange as described above.

Court cases provide some level of insight into some of the potential tax concerns that may arise with respect to these transactions. Going back to the definition of a Section 1031 exchange, not only do the exchange properties need to be real property in nature but they must also be *held* for investment or for use in a trade or business. The connotation of the term "held" is that for example the replacement property cannot simply be sold following the exchange, but rather has to be retained for investment purposes or used as a part of the taxpayer's business. Further, the relinquished property must be held for investment or used in the taxpayer's business for a period of time, rather than acquired for the purpose of carrying out the exchange. Although the statute does not define the period of time the property must be held, *Wagensen* sets a precedent.[20] On September 19, 1973, Mr. Wagensen, an 83-year-old partner in a ranching entity, entered into an agreement to carry out a Section 1031 exchange of ranch property. Title to the replacement property was acquired on January 18, 1974. On November 8, 1974, the taxpayer gifted the replacement property to his children and wife. The case concluded that this gift—even given the short timeframe—did not exclude the taxpayer from nonrecognition treatment. The case states that "at no time prior to petitioner's announcement did his children have any indication that the gift would be made." In essence, the replacement property was received in order to carry on the partnership's ranching business, and then just happened to be gifted shortly thereafter. The intention at the time of the swap was to hold and use the property in a trade or business.

In a drop and swap, a short holding period of the distributed assets also may cause the entity to be considered the seller in the transaction. Therefore, the distribution and involvement of the owners would be ignored altogether. In *Court Holding Co.,* a corporation carried through with a liquidating distribution of property to its owners after engaging in initial sale negotiations with respect to the property.[21] Shortly thereafter, the owners then exchanged the distributed property in what they were claiming to be a Section 1031 exchange. The Court found that the transaction was merely a formality that had occurred in order to avoid tax. Although the form of the transaction was a distribution to owners, ultimately the substance was held to be that the corporation (not the owners) had sold the property. Therefore, the transaction was excluded from nonrecognition treatment under Section 1031. Further, Rev. Rul. 77-337, 1977-2 CB 305 provides another example where a drop and swap transaction did not pass muster. Here, the focus was not on the holding period as much as the use of the asset swapped. The fact that the corporation used the property in its trade or business did not translate to qualifying the owner as using the property in a trade or business following distribution. Therefore, no Section 1031 exchange was allowed. Overall, great care should be placed on drop and swap transactions as the holding period and intention of the transaction could dramatically alter the availability of nonrecognition treatment.

Reorganization

Entities investing in real estate are often organized as partnerships. This provides for flexibility in waterfall distributions, along with the benefit of distributing property to partners tax free. To acquire property, these partnerships often buy entities that hold the desired land or buildings. While various strategies are available to accomplish this goal of entity and property purchase, the use of a Section 368(a)(1)(F) reorganization provides flexibility and potential tax deferral. These transactions, commonly known as "conversion" transactions may accomplish four goals:

1. purchase of an S corp by a partnership,
2. step-up of asset basis to the buyer,
3. opportunity for participation in future appreciation in a tax efficient manner,
4. if desired, issuance of profits interest to employees.

Although a seemingly complicated process, conversion transactions may provide an option to accomplish all four goals. The transaction can generally be executed as follows:

1. Buyer 1, LLC is a partnership that wishes to purchase 90% of S corp ABC, Inc. ABC, Inc. holds a building and land. Considering Buyer 1, LLC is a partnership, they cannot be a shareholder in an S corp without terminating the S election.
2. Conversion, Inc. is created. An S election is filed for Conversion, Inc., ensuring that this entity is not taxed as a C corp.
3. The shareholders of ABC, Inc. contribute their interest in ABC, Inc. into Conversion, Inc. ABC, Inc. is now a wholly owned subsidiary of Conversion, Inc. Conversion, Inc. files a Qualified Subchapter S Subsidiary Election (QSub Election) for ABC, Inc. by filing Form 8869. Q-subs are treated as disregarded entities for tax purposes. As a result, now, ABC, Inc., and Conversion, Inc. are generally considered the same entity for tax purposes.
4. ABC, Inc. is then converted to an LLC under state law, usually at least a day after the QSub Election is made. This conversion is generally considered a tax-free Section 368(a)(1)(F) transaction as it is a "a mere change in identity, form, or place of organization of one corporation, however effected."

Option A- Purchase of entity, Liquidation of ABC, LLC.

5. Buyer 1, LLC purchases 90% of ABC, LLC (and therefore 90% of its assets) for cash. Buyer 1, LLC obtains a stepped-up basis in the building and land equal to the cash paid for the property.
6. The owners of Conversion, Inc. (and therefore indirectly the owners of ABC, LLC) contribute the remaining 10% interest of ABC, LLC into Buyer 1, LLC. These owners receive a corre-

sponding interest in Buyer 1, LLC, and may be able to defer recognition of the remaining built-in gain on the assets of ABC, LLC. That is, the tax basis of 10% of the land and building carry forward in Buyer 1, LLC. This 10% contributed interest is referred to as "rollover interest" and it creates a Section 704(c) built-in gain or loss.

Option B- Interest purchase, ABC, LLC investment of Buyer 1, LLC.

7. ABC, LLC wants to provide a profit interest to an employee of the company, and Buyer 1, LLC agrees. The profits interest is granted in ABC, LLC, which makes ABC, LLC a recognized multimember partnership. If structured properly as true profits interest, no gain or compensation income would generally be recognized upon the issuance of this interest.
8. Buyer 1, LLC purchases 90% of Conversion, Inc.'s interest in ABC, LLC. Buyer 1, LLC will receive a Schedule K-1 from ABC, LLC for its investment.
9. A Section 754 election is made by ABC, LLC. Assuming the purchase of the partnership interest is for more than the partnership's tax basis in its assets, it would result in a Section 743(b) positive basis adjustment (step-up) for Buyer 1, LLC.

There are a few benefits to these conversion transactions. First and foremost, the result of this transaction is for partnership ownership of assets rather than S corp ownership of assets. While S corps are generally more straightforward when it comes to compliance complexity, they are limiting given the requirements for that entity type. All distributions must be pro-rata, a limited number of owners are possible, only certain types of owners are eligible, and distributions of property could result in gain recognition. Overall, partnerships generally provide more flexibility, and in the case of a conversion transaction, the potential for tax efficient participation in future appreciation.

An interesting nuance to "Option A" discussed above is the existence of a "rollover interest." Functionally, the assets within Buyer 1, LLC are split into two buckets: 1) purchased assets, and 2) rollover interest assets. For bucket 1, the deemed purchased assets get a stepped-up basis equal to the amount paid. Allocations of depreciation and amortization associated with this basis will vary depending on the Section 704 methodology chosen as discussed later in this article. The deemed purchased assets have depreciable lives that start as of the date of the transaction. Further, accelerated depreciation (and potentially bonus depreciation depending on the year) could be available on these assets assuming they qualify. Essentially, they are treated as "new" assets within Buyer 1, LLC. Buyer 1, LLC takes a tax basis in the rollover portion of the assets equal to ABC, LLC's basis, bucket 2. Section 704 provides special accounting rules which are used to ensure that the allocation of tax items, such as income and deductions, align with the economics of the partnership arrangement. Prior to a partner's contribution of assets to a partnership, the tax basis and 704(b) basis (book basis) of the partnership would likely be the same. Upon contribution of assets in which fair market value differs from tax basis, these two then diverge. The 704(b) basis of the assets equals the fair market value of these assets. Therefore, the difference between the fair market value of the rolled-over interest in assets and the tax basis of those assets creates a Section 704(c) built-in gain or loss. Theoretically, the built-in gain or loss should affect and "follow" the contributing partner. How this is accomplished, however, depends on the 704(b) method agreed upon by the partners in the partnership agreement. In practice, partnership agreements are often time silent to 704(b) method, so further consideration of the method should be agreed upon by owners or management. The primary methods available are:

1. traditional,
2. traditional with curative allocations, and
3. remedial.

Considering 704(b) depreciation is different than tax depreciation due to the basis differential, the various 704(b) methods attempt to "correct" the variance in 704(b) capital and tax capital by allocating depreciation, amortization, gain, or loss in specific ways over time. Therefore, different methods may favor the contributing party versus the non-contributing party, depending on the partnership's situation.

The traditional method is often the default method that partnerships use in this situation. Prior to the sale of any property or interest, the "reckoning" between tax and book basis is accomplished through allocations of amortization or depreciation. First, 704(b) book depreciation and amortization are allocated pro-rata. Then, under the traditional method, non-contributing partners are allocated tax depreciation or amortization equal to their pro-rata 704(b) allocation. Next, the contributing partner is allocated the remaining tax depreciation or amortization.

For example, assume there is a two-party partnership in which there is one contributing partner and one noncontributing partner. The contributing partner is the owner that contributed property with a potential built-in gain or loss, while the noncontributing partner purchased their interest in cash. Further, there is a 704(c) built-in gain, of which all is attributed to depreciable assets only. In this example, the 704(b) depreciation would be greater than the tax depreciation. As a result, the contributing partner would be allocated less tax depreciation than the non-contributing partner and the difference between the contributing partner's tax and book basis is eaten away by the variance between their tax and 704(b) allocation of depreciation. Therefore, in a perfect world, under the traditional method, the contributing partner would gradually feel the impact of the 704(c) built-in gain, while at the same time would incrementally rectify their 704(b) and tax basis.

An interesting nuance to the traditional method, however, is known as the "ceiling rule." Although ideally there would be sufficient tax depreciation for a noncontributing partner to receive equal tax and 704(b) depreciation, that is not always the case. If there is not enough tax depreciation to cover the noncontributing partner's 704(b) depreciation, then the noncontributing partner now has a distortion between their tax and 704(b) basis, even though they did not contribute any property themselves.

The traditional method with curative allocations attempts to correct this issue. If the ceiling rule were to kick in, leaving the noncontributing partner short on their tax depreciation allocation, the curative allocation would rectify this difference. In this example, there would be 704(b) income allocated to both the contributing and non-contributing partners equal to the otherwise present "variance" in the noncontributing partner's tax and 704(b) depreciation. This would increase the 704(b) basis of the noncontributing partner and would equalize his tax and book basis balances. This method then requires an overall tax allocation equal to the additional 704(b) allocation. The contributing partner now has to recognize taxable income equal to the 704(b) curative allocation of income for both the contributing and noncontributing partner, while the noncontributing partner recognizes no further adjustments to taxable income. Ultimately, this keeps the overall book and tax basis impact of the curative allocation equal when looking at the cumulative amounts on the partnership level. Therefore, curative allocations are often an unfavorable method for the contributing partner.

The remedial method, on the other hand, provides a different approach to correcting this variance. Instead of requiring both a tax and 704(b) impact to correct the difference, in the remedial method the noncontributing partner is first given a tax allocation to equalize the amount of tax depreciation up to the pro-rata 704(b) depreciation allocation. Then, the contributing partner is given taxable income so that the overall partnership taxable income is not affected. In essence, the contributing partner is allocated the inverse of what the noncontributing recognizes as the taxable income correction to their tax basis capital account. Therefore, this method could prove either beneficial or harmful to the contributing partner, depending on whether there is a taxable income or loss allocation to them.

With all of these methods available, method selection can have real taxable impacts on partners based on which method is chosen. As a result, this is an important decision that should be discussed between parties prior to any transaction in which property is contributed or rolled over to a partnership.

While potentially complicated to carry through, the real estate industry does currently have a variety of tax strategies to take advantage of. Whether it be exchanging property via a Section 1031 exchange, taking advantage of a TIC structure, or purchasing or selling property via a conversion transaction, taxpayers should be aware of the advantages and drawbacks of each. Even though this article does include conversation on some of the rules surrounding these transactions, it is not intended to be all-encompassing. There are many exceptions, examples, and nuances in this space that are outside the scope of this article. Further, the risks and benefits associated with any particular tax strategy will vary based on the taxpayer's individual facts and circumstances, so consulting a tax advisor prior to any transaction is always wise. ■