LLC's and Section 1031 Exchanges

An Exchangor can achieve great liability advantages and tax advantages by using a Limited Liability Company (LLC) in a 1031 exchange.

An LLC is a form of business organization that is available in almost every state.

Liability Advantages:

With a properly set up and operated LLC, liabilities are limited to the assets of that LLC. An investor can protect his or her assets that are not part of the Limited Liability Company.

Caution: Even with an LLC, the investor is individually liable for any loans guaranteed by the investor. Even with an LLC, the investor is individually liable for any claims for damages where the investor (as opposed to the investor's agent) directly caused the damages.

Tax Advantages:

With the advent of the "check the box" regulations, an investor can choose to have the LLC taxed as a flow through entity. The LLC will not have a separate tax rate or tax liability. The profits and losses of the LLC will "flow through" to the owner(s) of the LLC.

An LLC offers:

- Limited Liability from claims for hazardous waste.
- Limited Liability from claims for operational liabilities.
- More acceptance by Lenders because a single asset LLC presents less bankruptcy problems for the lender.
- Flow through (partnership) tax treatment for its owners (members)
- Increased Estate Planning Opportunities.

In short, an LLC combines the best features of a corporation (limited liability) with a partnership (flow through or no entity level tax treatment).

Making effective use of an LLC in a 1031 exchange requires an understanding of the interplay of exchange and LLC ownership issues.

Issue: The same party that started the exchange must complete it.

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Example: A single owner LLC is ignored for tax purposes. The single owner is treated as though that owner owns the property **individually** for tax purposes. A separate tax return (Partnership 1065) is **not** required. An individual can start an exchange as an individual and finish the exchange as a single owner LLC. For tax purposes, the individual who owns the LLC is treated as the property owner even though the property is owned by the LLC.

Issue: A two (or more) owner LLC (except for husband and wife in a community property state) is **not** ignored for tax purposes. The individuals who own the LLC are **not** treated as though they own the property **individually** for tax purposes. The LLC is required to file a separate tax return (Partnership 1065). Two or more individuals **cannot** start an exchange as individuals and finish the exchange as an LLC which files a partnership return. For tax purposes, the LLC is treated as a different property owner than the individuals who own the LLC.

Until recently it was not clear whether an LLC formed by a husband and wife living in a community property state would be treated as a single owner LLC or a two owner LLC. The answer to that question was critical on how to structure an exchange with an LLC.

Now we have the answer. Revenue Procedure 2002-69 issued on October 10, 2002 finally makes it clear that an LLC jointly owned by a husband and wife in a community property state, such as Washington and California, will be treated as a single owner LLC. The husband and wife will be treated as one owner rather than two owners of the LLC. A separate tax return (Partnership 1065) will not be required.

The result of this clarification by the IRS is that in a community property state husband and wife can achieve a qualified 1031 exchange and still have the benefits of an LLC.

Example: Dave and Sally are married to each other and live in a community property state. They own a 5 unit rental building as community property. They wish to exchange for a 10 unit building. They have been reading up on LLC s and decide they want the protection of an LLC for their new investment. Can Dave and Sally structure their exchange so that they end up owning the new property through an LLC?

The following approach assumes a properly documented and completed facilitator-assisted exchange with the husband and wife as community property owners of the old property:

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Dave and Sally could form an LLC in time to acquire the new property. Dave and Sally would not transfer the old property to the LLC. Dave and Sally would continue to operate the old property titled in the their names until the sale of the old property closes. The exchange would be documented in their individual names. They would sell the old property as individuals but acquire the new property in the name of the LLC.

The LLC which is owned only by Dave and Sally would be treated as a single owner LLC.

The Exchanging parties, Dave and Sally, who started the exchange as individuals would finish the exchange as an LLC. For tax purposes the LLC is treated as a single owner LLC. For tax purposes, the LLC ownership is treated as though Dave and Sally had acquired the new property. Dave and Sally continue to report the tax attributes of the apartment building on Schedule E of their individual return. The exchange would qualify.

Revenue Procedure 2002-69 gives tremendous comfort to husband and wife property owners in community property states. The husband and wife can combine the limited liability advantages of an LLC with the tax benefits of a 1031 tax -deferred exchange.

Caution: This Revenue Procedure only gives comfort to husband and wife property owners in community property states. The nine community property states are as follows:

Arizona
California
Idaho
Louisiana
Nevada
New Mexico
Texas
Washington
Wisconsin

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