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Will New IRS Guidelines Ease Property Disorder?

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From The Wall Street Journal Online

There's good news and bad news about recent Internal Revenue Service guidelines on real-estate sales.

The good news is that the guidelines provide clarity for people who choose to exchange properties to defer taxes. The bad news is they contain certain caveats that may give some investors pause.

The new guidelines issued by the IRS in March, known as Rev. Proc. 2002-22, were intended to give guidance to real-estate buyers and sellers who conduct certain types of 1031 exchanges. In a 1031 exchange, owners defer gains on the sale of their property by exchanging it for a "like-kind" property. By doing this, sellers are able to put off paying capital-gains taxes.

In most cases, an independent third-party intermediary prepares the exchange agreement and handles the money. The property the seller wants to buy has to be identified within 45 calendar days of his sale and purchased within 180 days.

A form of the 1031 exchange, so-called tenancy-in-common-interest structures, has been conducted for years. The structures allow sellers to make an exchange by buying an interest in real-estate properties as opposed to entire properties. They provide relief for sellers who can't find within the 45-day deadline an exchange property they like, can afford, or that requires little to no day-to-day property management.

The problem with these structures is that they could be viewed as partnerships, and as such, selling or buying interests would be prohibited under the statutes governing 1031 exchanges. For years, investors have been flying blind, uncertain of whether their deals qualified. They often requested individual rulings from the IRS.

Now with the new guidelines, the IRS is trying to help investors define their tenancy-in-common-interest structures and streamline the requests by giving them criteria that generally must be met from the start. The IRS says each structure can apply for a private ruling letter on whether it should be treated as a partnership or corporation for tax purposes.

If a structure is considered a partnership, investors would have to restructure in order to comply with the guidelines or scrap the structure. They also could face a tax liability for the period.

"It's very good for the industry to have guidelines people really didn't have before," says Rob Hannah, chief executive officer of Tax Strategies Group LLC, Chicago, which provides fractional interests in real-estate assets to 1031 buyers.

But the IRS's guidance wasn't the broad, one-size-fits-all green light that some real-estate investors and lawyers would have preferred. Attorneys say it can take at least six months for the IRS to respond to a ruling request.

What's more, there are 15 conditions that ordinarily must be met for the IRS to consider a ruling request. The condition causing "the most heartburn," says Louis S. Weller, a principal at Deloitte & Touche LLP's national real-estate tax services group in San Francisco, is the one where the sale of a property must be agreed upon by all co-owners.

Mr. Weller plans to meet with officials at the Treasury Department tomorrow to discuss the guidelines in general but the unanimity issue in particular. "We want to know if they'll consider alternatives to this requirement," he says.

IRS officials declined to comment.