Legal 1031 Exchange Services, LLC
a Kensington Vanguard Company

1031 Exchanges & S-Corporations

Real property held in S-corporations can present tax challenges in conjunction with a 1031 exchange when one or more shareholders have differing exit strategies- whether to cash out or exchange in their own capacity. Unlike the strategies utilized in partnership breakup exchanges, in most cases a distribution from the corporation will trigger gain recognition for all shareholders.

The underlying problem is that general corporate tax treatment requires that distributions from the corporation are allocated pro rata to the shareholders based on their ownership in the property, As a result, a cash out upon the sale of the property will trigger gain allocation for all shareholders. However, the existing shareholders may be redeemed for their individual shares prior or after the exchange.

Unfortunately, the strategies generally implemented with partnership breakups will not achieve the desired results with an s-corporation:

- *Distribute TIC interest to exiting shareholder and sell as tenants in common – general corporate rules apply to distributions from an s-corporation, therefore gain would be allocated to all shareholders.*
- *Installment notes - the s-corporation would recognize gain at the time of distribution of the notes and allocate proportionately to the shareholders, unlike partnership rules where the partners would only recognize gain upon receiving payment on the note.*
- *A special allocation of gain to exiting/non-exchanging partner – is not available if the entity is a corporate taxpayer and gain is allocated pro-rata in an S-Corp. In the partnership context, this strategy can present some tax risk.*

Although more limited than partnership options, S corporation shareholders may consider various options, in conjunction with their tax advisor, including but not limited to:

OPTION 1 – Redemption of exiting shareholder.
The remaining shareholder(s) buys-out the exiting shareholder(s) prior to proceeding with a 1031 exchange (by doing so the remaining shareholder could inherit all depreciation recapture and built in gain, so in-depth analysis is recommended). The challenges are that the remaining shareholder will not only need to come up with funds for the buyout but will then need to reinvest the full net sale price to maximize the 1031 exchange deferral.

OPTION 2 – Refinance and redeem.
S-corporation completes the 1031 exchange and after some time leverages the replacement property to cash-out and retire the shares of the departing shareholder(s), then continues on. Similar to Option 1, the exchange value would be the full net sale price of the property and absorb potential costs of the 1250 recapture. This option requires some pre-planning prior to moving forward because if debt is taken on at the corporate level, the individual shareholders may not be able to increase their basis in their shares accordingly, leaving a disparity and some in-depth accounting and analysis is necessary.

OPTION 3 – Tax-free corporate division if all parties plan to exchange in to like kind property.
The S-corporation can divide tax free into multiple entities in conjunction with an exchange and shareholders identify and acquire separate replacement properties through disregarded subsidiaries as part of the exchange. Both the relinquished and replacement properties are subject to active management requirements and the resulting corporations must actively conduct trade or business to maintain continuity of the business enterprise requirements. Cash out scenarios typically don't maintain the continuity requirements. These are complex reorganization structures that need to be thoroughly vetted with one's tax advisor.