1031 Exchange

Buying with a Partner

Internal Revenue Code Section 1031 allows deferment of capital gains taxes on real property used in trade or business or held for investment

A very common question that we get asked is "Can I do a 1031 Exchange and buy replacement property with a partner". The answer is always, "Yes, but...". When buying with a partner, there are a few very important considerations:

1. The replacement property must qualify as an investment or business use property. Remember, this is a 1031 Exchange, so replacement property should produce rental income that is reported on your tax filings. The property should be depreciated and all expenses should be tracked and reported on a Schedule E. 1031 Exchange funds cannot be gifted to a child to help them acquire a primary residence. Likewise, you cannot purchase a second home in Palm Springs with your best friend.

2. You will need to acquire enough replacement property to satisfy your 1031 Exchange. If you purchase replacement property with a partner, your share of the property needs to meet or exceed the value of what you sold. For example, if you sold a rental home for $500K and acquire replacement property for $1M, you will need to own at least 50% of the replacement property. Likewise, if the replacement property is purchased for $2M, you will need to own at least 25%.

3. Properly allocate the burdens and benefits of ownership. The distribution of rental income, expenses, depreciation and mortgage liabilities should all be in accordance with the ownership percentage. If you own 35% of the property, you should receive 35% of the rental income, expenses and depreciation. You should also be responsible for 35% of the mortgage.

4. Buying replacement property with children is tricky. Many of our clients want to help their children by their first home, so they plan to sell a rental and 1031 into a property that their children will live in. This can be done, but needs to be done correctly:

- You cannot simply give your 1031 funds to your child as a down payment for their primary residence. There are a lot of problems with this, so don't even try it.
- Your child can live in the property you purchase in your 1031 Exchange but they will need to pay you rent. The kids should also pay fair market value rent. Charging your child $100/month will not fly. Remember, your 1031 Exchange property needs to be a valid investment property, so treat it as such and collect rent, report expenses and depreciate the property, even if it's Johnny Jr. who's living there.
- Your child can co-own the property with you, but a) you need to own enough of the property to satisfy your 1031 as mentioned above and b) the kids need to pay you rent for your share of the property. If you own the property 50/50 with your kids, they need to pay you 50% of the fair market value rental rate.
- It is best to treat the child like any other non-related tenant or co-owner. Execute a lease agreement, split the expenses based on the ownership percentage, etc.

5. Create a Tenant in Common Agreement. Although it is not required, it is good practice to structure a TIC agreement that outlines the terms of ownership, how disputes between the owners will be resolved, management responsibilities and exit strategies. A little bit of planning up front can save quite a bit of headaches later down the road.