

Joint Ownership Arrangements Can Be Treated As Partnerships For Tax Purposes

By Bob Ciancola

When individuals pool their money to buy a piece of real estate, they may not realize that they may have inadvertently formed a partnership for tax purposes. When property, whether real or personal, is jointly owned by two or more persons, the ownership arrangement can, in many cases, be treated as an entity separate and apart from the owners for federal income tax purposes. The fact that such an arrangement is not treated as a legal entity under state law is not controlling because federal tax law determines independently whether or not a separate entity exists. Federal tax law tends to be significantly broader than state law in finding that a separate entity has been created. Whether or not a separate entity exists can be very important because, among other reasons, the entity will have to file an income tax return and make tax elections which bind the owners. Further, in the context of a section 1031 swap, the finding that a separate entity exists can invalidate the non-recognition of gain.

Tax Guidelines for Determining When a Separate Entity Exists.

U.S. Treasury regulations provide that a joint venture or an action under contract will constitute a separate entity for tax purposes if the participants carry on a trade or business, financial operation or venture, and divide profits. However, mere co-ownership of property which is maintained and rented does not create a separate entity. Thus, in a published ruling, the IRS has held (Revenue Ruling 75-374) that two individuals who owned real estate and hired an agent to collect rents, pay real estate taxes and insurance, keep the property in repair, and provide normal tenant services such as trash removal, did not thereby create a partnership. The fact that they used an agent to perform these tasks is not significant, since the agent's actions are attributed to the principals. One key in this ruling is that the individuals owned the property as joint tenants. If the ownership is through an entity recognized under state law, the entity will be recognized for tax purposes as well. Thus, if two investors own a parcel of property as joint tenants and do no more than maintain it and collect the rents, no entity will arise. If those same owners owned the property in a limited liability company, they will have formed a partnership for tax purposes.

Electing Out of Subchapter K

In some cases, arrangements which would be treated as partnerships can elect out of subchapter K (the part of the Internal Revenue Code dealing with partnerships) and avoid the necessity of filing income tax returns. To be eligible for electing out, the ownership arrangement must be (1) for investment purposes only and not for the active conduct of a business, or (2) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted. In the case of investment property, the participants must own the property directly as co-owners, retain the right to separately sell or transfer their interest in the property, and not give anyone the authority to sell the entire property, including the interests of the other owners. The manner of electing out can be either an express election filed with the IRS at the time the first

partnership return would be due or without an express election if the owners indicated in writing their clear intention not to be subject to subchapter K at the time they acquire the property or form the association. Electing out of subchapter K will render the owners eligible for a section 1031 exchange.

Section 1031 Exchanges

Last year the IRS published an important revenue procedure dealing with when joint ownership of property will be considered an entity, thus disqualifying the property from section 1031 treatment. This procedure is actually a list of factors which must be considered when applying for a private ruling that such an entity does not exist. Among the factors listed are: (1) the owners must own the property as joint tenants; (2) the total number of owners cannot exceed 35; (3) the owners cannot conduct business under a common name; (4) decisions to sell the property or hire a manager must be by unanimous consent of the owners; and (5) profits, losses, proceeds of sale and debt must all be shared in proportion to each owner's interest in the property. In addition to these factors, several others are listed in the revenue procedure. Whenever joint owners decide to engage in a section 1031 exchange, it is important that they seek competent professional advice.

Bob Ciancola is an attorney in Scottsdale practicing in business transactions, tax law and estate planning. He may be reached at 480 346-1080 or on his website at www.ciancolaw.com.