

1031 EXCHANGES AND SINGLE-MEMBER LLC'S - IS THE NEW HAMPSHIRE DRA CREATING SOMETHING OUT OF NOTHING?

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As some readers may be aware, the New Hampshire Department of Revenue Administration (the "DRA") has recently been auditing and assessing taxes on completed transactions involving section 1031 exchanges. The DRA is targeting section 1031 exchanges involving single member limited liability companies ("SMLLC") and certain tenants in common interests and, as further discussed below, is taking a position that conflicts with the federal law to the surprise of unsuspecting section 1031 participants.

Section 1031 of the Internal Revenue Code of 1986, as amended (the "Code"), provides an exception from the general rule requiring the current recognition of gain or loss realized upon the sale or exchange of property. Under Section 1031(a), no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of "like-kind" that is to be held either for productive use in a trade or business or for investment. This allows taxpayers to defer any gain until the "exchange property" is disposed of in a subsequent taxable transaction.

The theory behind section 1031 is that when a property owner has immediately reinvested the sale proceeds into another property, the economic gain has not been realized in a way that generates funds to pay any tax. In other words, the taxpayer's investment is still the same, only the form has changed (e.g., vacant land exchanged for apartment building). Therefore, it would be unfair to force the taxpayer to pay tax on a "paper" gain and the taxpayer is properly allowed to defer any gain until the sale of the replacement property when, and if, gain is recognized.

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Inherent in section 1031 is the requirement that the taxpayer who transfers the relinquished property also receive the replacement property. With the increasing popularity of the use of limited liability companies to hold real property for liability purposes and the requirement of many lenders that borrowers form a single purpose bankruptcy remote type entity to hold replacement property, many practitioners counsel clients to use a SMLLC in connection with acquisition of real estate. As a result, SMLLCs have become common participants in Section 1031 exchanges. This is possible because for federal tax purposes, SMLLC's are treated as "disregarded entities" and not a separate taxable entity from its owner. See Regs. § 301.7703-3(b)(1)(ii). Accordingly, a taxpayer who owns property individually or in a SMLLC (i.e., SMLLC #1) may enter into an otherwise properly structured Section 1031 exchange and receive and hold the replacement property in a newly formed SMLLC (i.e., SMLLC #2). The IRS has stated that an immediate transfer of replacement property into a SMLLC will not cause disqualification under Section 1031. Therefore, entities that are disregarded for federal income tax purposes are disregarded for purposes of Section 1031. See also Rev. Rul. 99-6, 1999-1 CB 432; Rev. Proc. 2002-22.

This result is seemingly a relatively straightforward application of the federal tax laws - if an entity is disregarded for federal income tax reporting, it should be disregarded in determining whether a transaction qualifies for section 1031 treatment. Recently, however, the DRA has begun taking the position that New Hampshire taxpayers participating in a Section 1031 exchange in which they did not take the replacement property in exactly the same name as the deed on the relinquished property (i.e., held the new property in a SMLLC), are subject to the state's Business Profits Tax in the year of the sale of the relinquished property. Simply put, the DRA is not recognizing an otherwise valid 1031 exchange where taxpayers are receiving replacement property in a new SMLLC on the basis that the SMLLC is a separate legal entity apart from the taxpayer that exchanged the relinquished property. The DRA is treating this as a plain sale of the relinquished property. The DRA did not publish any notifications, information release or proposed regulations regarding their treatment of 1031 exchanges using SMLLC's, rather they sent Notice of Assessments to several New Hampshire taxpayers assessing BPT taxes, penalties and interest for the transactions. Although the DRA has not clearly set forth their position and reasoning, the Commissioner stated in a letter to the HB-2 (Budget) Committee of Conference Members dated June 15, 2009, that:

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“Like-Kind Exchanges: New Hampshire’s Business Profits tax is unique in that it is not complemented by a broad-based personal income tax. Because taxability is limited to ‘business profits’ and not wages or salary, it is necessary to apply the statutes in a way that treats all business organizations as similarly situated as possible, in the interest of fairness and equity. New Hampshire, therefore, treats every type of business organization, whether a proprietorship, partnership, limited liability company, or corporation, as a separate taxable entity, regardless of the federal tax status of a given entity. This includes so-called disregarded entities such as single-member limited liability companies (“SMLLC”). There are instances in which this distinction requires different treatment than that offered under the internal revenue service. DRA is currently working to address this issue through a rulemaking procedure.”

To date, the DRA has not further clarified their position through proposed rules.

The DRA’s position and reasoning (although the reasoning has not been fully clarified) of assessing the BPT on New Hampshire taxpayers that used an SMLLC in a 1031 exchange is seemingly flawed. The BPT uses, as its starting point, federal taxable income. The New Hampshire General Court adopted this approach when it enacted the BPT and in doing so, it incorporated the federal income tax methods of determining taxable income. This approach also incorporates the federal adjustments to the basis of the assets held for business use. See *Shangri-La, Inc. v. State of New Hampshire* 113 N. H. 440 (1973). The calculation of gain or loss for the sale or exchange of business assets for BPT purposes is determined by applying the federal principles related to the amount realized from the transaction and deducting the federal adjusted basis of the asset at the time of the sale or exchange.

In the case of the like-kind exchanges entered into by taxpayers, there is no recognition of gain until such time as the replacement property is sold or exchanged in a taxable transaction. The basis of the property received in the like-kind exchange is the carry over basis from the property given up by the parties in the transaction. Since the taxpayers do not have any federal taxable income from the transactions, there is no income from these transactions that the BPT incorporates into the New Hampshire tax system. The adjustments to federal taxable income that the General Court authorized are incorporated into RSA 77-A:4, Additions and Deductions. The subparagraphs I through XVI contained in RSA 77-A:4, are the only adjustments permitted to



federal taxable income. There is no adjustment under the Additions and Deductions section that provides the authority for the DRA to increase the amount of federal taxable income whether it would be reported by the taxpayers directly to the Internal Revenue Service or included on the member's personal federal income tax return.

Under the Code, SMLLC's are disregarded entities requiring the inclusion of the income on the member's individual return. The IRS has clearly indicated that the use of SMLLC and other disregarded entities in connection with a properly structured 1031 exchange is appropriate. The IRS has stated that an immediate transfer of replacement property into a SMLLC will not cause disqualification under Section 1031. Priv. Ltr. Rul. 9850001. In addition, the IRS has issued several private letter rulings concluding that an acquisition of a single member LLC interest will be treated as an acquisition of the underlying property. See, e.g., Priv. Ltr Rul. 9751012, 9807013, and 199911033. Therefore, the SMLLC and its owner are viewed as the same taxpayer and there is no additional tax incurred solely due to the use of a disregarded entity in a 1031 exchange transaction. New Hampshire's requirement that the income and expenses for separate business organizations be reported by the business organization itself rather than the owner merely shifts who is required to report the federal taxable income and it does not create federal taxable income where there was none for federal tax purposes.

There are currently several cases in various stages with the DRA regarding these very issues and hopefully there will be a resolution and/or further clarification in the near future. Taxpayers and interested businesses groups have raised this issue with state legislators and two state senators have proposed legislation to allow the use of SMLLC's in 1031 exchanges without incurring a state tax. It is unclear how much support this legislation will have in the current economic climate and given the state budget constraints. However, it is clear that the DRA is scrutinizing 1031 exchanges and is willing to disregard exchanges involving SMLLC's that are otherwise compliant with the Code.

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