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What owners of rental units should know about condo-conversions and 1031 exchanges

Can the owner of a rental property convert the asset into condominiums and still claim non-recognition of capital gain under Section 1031 of the Internal Revenue Code?


BRESSLER

Under Section 1031, a taxpayer may exchange property held for productive use in a trade, business or investment for another "like-kind" property also held for productive use in a trade, business or investment without recognizing gain or loss. The ability to delay recognition of gain is an important tool for taxpayers. Non-recognition of gain defers the tax liability arising from the sale and allows the taxpayer to apply those savings towards the purchase of a replacement property.

Owners of rental properties often seek to complete a Section 1031 tax deferred exchange by selling their property and investing the proceeds in a "like-kind" investment property. The purchase of another apartment or office building or even condominium units, if held for investment, can often qualify as like-kind replacement property. However, the conversion of a rental property to condominium use may not easily qualify for a 1031 exchange, even if the taxpayer owned the rental property for many years prior to the conversion, as we shall explain.


WITTLIN

An owner of rental property considering a sale of his asset may conclude that condominium conversion would maximize profit based on the proposition that the sum of individual unit sales would exceed the value of the property. However, upon conversion of the asset to condominiums, since the purpose is to sell — rather than rent— each of the condominium units, the taxpayer may have turned his property into inventory. As such, the property may no longer be subject to tax deferred treatment under Section 1031. The IRS, therefore, may deem the taxpayer who created the condominium a dealer in properties, and the units may be viewed as inventory. Therefore, the property would not be eligible for a 1031 exchange. Furthermore, in such an instance, the sale of the condominium units may be taxed at the more onerous ordinary income tax rate rather than the capital gains tax rate.

For a taxpayer to claim tax deferred treatment under Section 1031 following condominium conversion, the taxpayer must avoid treatment as a dealer in condominiums. If the taxpayer is treated as a dealer in condominiums he may be subject to ordinary income as discussed above.

In conclusion, the owner of a rental property may, only in limited circumstances, convert the property into condominiums and still claim non-recognition of capital gain upon sale. From a pragmatic standpoint, Section 1031 treatment does not seem appropriate where lenders have provided substantial construction financing for the conversion since the taxpayer would be compelled to sell units quickly to meet payment obligations arising from the construction financing. The IRS may view these units as inventory held for sale, rather than investment property held for productive use. Likewise, a 1031 exchange would not seem appropriate in large condominium developments given the risk that the IRS will deem a large number of unsold units as inventory held primarily for sale.

IRS Revenue Rulings offer the taxpayer limited guidance for establishing what types of property are deemed held for "productive use" in a trade, business or investment as compared to property considered inventory and held primarily for sale. A taxpayer converting property to condominiums who seeks to conduct a 1031 exchange must proceed carefully or risk adverse tax consequences. Taxpayers should consult with a knowledgeable tax attorney or advisor before deciding to claim tax deferred treatment for a property converted to condominium use.

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