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Exchanging Fractional Ownership Interests Under Section 1031

Fractional ownership, also known as interval ownership, is becoming an increasingly popular form of property ownership in resort areas across the country where the cost of property continues to rise.

Fractional ownership is an arrangement in which multiple individuals or entities hold shared legal title to a single parcel of real estate or a condominium unit. Each owner owns a fraction of the total ownership.

This arrangement allows those who might not otherwise be able to afford the resort lifestyle to do so by sharing the expense of ownership with others.

How does a fractional interest work?

Fractional ownership interests are similar to tenancies in common in that the owners receive a deed for a specific undivided interest in the property. Some states, like Hawaii, allow only a limited number of fractional owners. Specifically, Hawaii restricts the number of fractional owners for a single property to six (see Hawaii Revised Statute 514A). Each owner is entitled to exclusive use of the property for only a designated period of time proportional to their ownership interest. For example, if there are six owners, each one is entitled to 1/6 of the total number of days in the year or 60 days a year. The fractional

owner receives a deed reflecting their fraction of the total ownership. The developer provides a Fractional Declaration or "Plan" which is a written document outlining the rules governing use and operation of the property by the fractional owners. Fractional owners pay a proportionate share of all expenses according to their ownership. If an owner has a 1/6 share of the property, that owner typically pays 1/6 of the taxes, insurance, repairs and remodeling.

Fractional owners also share in the management of the property.

Many developers will provide financing to purchasers of fractional interests, but there are also conventional lenders who are now providing loans on fractional ownership interests.

Can these fractional ownership interests qualify as like-kind property in a real estate exchange?

The answer is yes. Unlike other forms of interval ownership, such as leasehold timeshares, the fractional owner holds direct legal title to the property, reflected by a deed, subject to restrictions on use and possession corresponding to their fractionalized ownership interest.

As long as the primary purpose of the fractional ownership is for investment

purposes rather than for personal use and enjoyment, the investment should qualify for tax deferral under Section 1031. There are two authorities that support this proposition:

(1) A 1981 PLR allowed 1031 treatment of a vacation home where the taxpayer intended to acquire property for personal enjoyment and as an investment. The IRS held that minor personal use should not render property ineligible for Section 1031 if the relinquished and replacement property are essentially investment property.

(2) The Treasury Regulations define qualified property as follows: Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is "held for investment" and not primarily for sale.

Early investment in fractionalized ownership developments means that investors will ultimately reap the benefit of rapid appreciation. Investors can maximize that benefit by considering a tax deferred exchange into other investment real property rather than simply selling their property and paying capital gains tax. This gives an investor the ability to leverage appreciation dollars that would otherwise be spent on taxes.

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