

ALERT: Use of Disregarded Entities May Cause Section 1031 Exchange to Fail for New Hampshire State Income Tax Purposes

It has been reported that the New Hampshire Department of Revenue takes the position that if (1) an exchanger sells property held in a single-member limited liability company or other entity, which is disregarded for federal tax purposes (a "DRE"), and (2) acquires property in a different DRE, then the exchange fails for New Hampshire state income tax purposes. All DREs, including single-member limited liability companies, disregarded limited partnerships, and grantor trusts doing business in New Hampshire with gross income everywhere in excess of \$50,000 are required to report and pay business profits tax. Because the business profits tax is assessed on an entity by entity basis, New Hampshire asserts that in order to enjoy §1031 deferral, the same entity that sold the relinquished property must subsequently purchase the replacement property.

This position may mean that several common tax and business planning techniques may inadvertently cause an exchanger to lose the benefit of §1031 for New Hampshire business profits tax purposes. For example, if an exchanger sells property owned by one DRE and for business or liability reasons acquires property into a different DRE, the exchanger may be required to recognize gain in the selling DRE.

It is unclear whether this position would apply to DREs organized outside of New Hampshire or to DREs that only hold out-of-state

property but the exchanger is subject to taxation in New Hampshire. However, the State of New Hampshire is likely to assert that this position does apply to these situations. In addition, New Hampshire residents exchanging out-of-state assets may find themselves subject to these rules.

Further, it is possible that this rule would apply if, rather than transferring or acquiring a deed in the underlying relinquished or replacement property, the exchanger transferred or acquired a 100 percent interest in a DRE. The IRS has held numerous times that the transfer/receipt of a 100 percent interest in a DRE in a §1031 exchange is the same as the transfer/receipt of the underlying asset. Accordingly, transfers of DRE interests in §1031 transactions are commonplace, especially in the context of acquiring parked replacement property from an EAT in a safe harbor reverse exchange under Rev. Proc. 2000-37.

Exchangers and their advisors subject to New Hampshire business profits tax are advised to use caution when exchanging properties held by an entity including a DRE.

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