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Real Estate Taxation

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MY BUILDING HAS EVERY (IN)CONVENIENCE: THE TAX TRAP OF CONDO REDEVELOPMENT

This article examines the redevelopment of aging condominium projects, an endeavor that can create major tax obstacles, including locked-in basis from demolition, taxable built-in gains, and uneven access to [Sections 1031](#) and [121](#), all of which can deter owners from pursuing otherwise beneficial reconstruction. A carefully structured LLC taxed as a partnership may centralize redevelopment and potentially defer gain under [Section 721](#), but complex disguised-sale, mixing-bowl, liability, and distribution rules make meticulous planning essential.

Introduction

Over 55% of condominium buildings in the United States are now more than 35 years old. Roughly a third of these properties serve as secondary vacation homes, and nearly 60% are owned by Americans over age 60.

These aging developments are becoming increasingly expensive to keep up. Many associations face a familiar list of problems: crumbling structures, years of deferred maintenance, badly underfunded reserves, and outdated plumbing and electrical systems. Those issues, in turn, make the units increasingly difficult to rent or sell. On top of that, older buildings lack the energy efficiency and climate resilience of modern construction, leaving owners to shoulder rising insurance premiums in the face of mounting environmental risks.

At the same time, older Americans hold a massive share of the country's housing wealth, often with significant unrealized gains. For these owners, selling their units can trigger a large capital gains tax bill, eating into the equity they need to fund retirement, buy their next home, or pass wealth to their children.

Oftentimes, the most effective solution to the problem of aging condominium developments is to tear down the existing building and construct a new property. In this scenario, the project may include additional units that are offered for sale to new buyers to help defray the costs of reconstruction and lessen the burden for existing owners, and for our purposes, we assume that a version of this scenario:

A developer will agree to demo and rebuild the development on behalf of the collective owners, with several new units being added to the project to help defray the costs; Each of the existing owners will walk away with new (and improved) unit that replaces the old unit, and the common improvements and building structure that serve those units will be modernized and enhanced.

***2** From a tax perspective, tearing down an old condo building and putting up a new one is a minefield. No matter how you structure a redevelopment, you are constrained by a set of complex and generally unforgiving income tax rules.

Section 280B and the 'Locked Basis' Problem

Assuming that the unit owners in a condominium development can reach agreement that the time has come to rebuild the units, significant barriers present themselves. Obtaining separate financing for each owner and negotiations between separate owners and a developer would be enough to scare away most rational parties. Assuming that the practical issues can be addressed, the income tax rules add an immediate problem for the project.

Before the wrecking ball swings, the income tax rules present a problem in the form of deferred cost recovery. Prior to demolition, each condo owner's tax basis is divided between owner's condominium unit, and their undivided interest in the common elements (including the land and structural components). As discussed later, each owner's adjusted basis in their respective unit may be subject to very different cost recovery regimes, depending on the owner's use of the unit. However, when a building is demolished, [Section 280B](#) steps in to prevent owners from immediately recovering the cost of the demolished property. Instead, [Section 280B](#) generally disallows current deductions for demolition expenses and prevents the owner from taking a loss deduction under [Section 165](#) for the destroyed structure.

Each owner's remaining basis in the demolished unit, plus their share of demolition costs, is capitalized into the basis of their undivided interest in the land. That basis is not lost, but it is effectively 'locked' in non depreciable land. The basis cannot be recovered through depreciation or an immediate loss, and will be recovered when the owner eventually disposes of the land (which, in practice, often means when they sell the replacement condo). Immediately after demolition, each owner is left with an

interest in bare land with an increased tax basis. When the new building is constructed, the replacement units get their own, separate cost basis equal to the new construction expenditures—unrelated to the 'trapped' basis in the land.

[Section 280B](#) sets the stage for the next problem: how to improve on the value of a well located condominium development, while modernizing the property, without forcing owners into immediate, and often prohibitively high, tax cost.

The Lock-In Effect of Built-In Gains

In theory, if every owner in a condominium agreed, they could simply vote to terminate the condominium regime, demolish the building, and rebuild. In practice, that level of consensus is exceedingly rare. For example, under the Colorado Common Interest Ownership Act, terminating a condominium association typically requires approval by at least 67% of the votes, and many declarations demand an even higher threshold—or unanimity. While Colorado's statute allows termination at 67%, more stringent provisions in the governing documents will control.

***3** This creates enormous holdout risk. A single owner can derail a multi year project. Because of that lenders are reluctant to finance a large construction project at the HOA level, and developers are hesitant to engage with dozens of individual owners where any one party may be able to stall the project after material effort and expense. However, perhaps the incentive of receiving a new condominium at a discounted cost will fill everyone's bucket... or perhaps it will poison the well.

As was the case with the demolition, receipt of a new condo unit may generate tax consequences for the owners that are surprising. Unless otherwise provided for in the Internal Revenue Code, our income tax rules require any receipt of property to be treated as 'gross income.' Obvious examples are payments for services, or cash gains realized on the disposition of investment property. Perhaps less obvious at first, gross income includes the receipt of property, which in this case would be the receipt of a new condominium unit. Since the old unit (and its basis) have been put in the ground, the excess of the fair market value of the property over the amount paid by the owner should be presumed to be income. If the owner receives property only, and no cash, the classic land-rich/cash-poor problem will make paying the income taxes on the receipt of that property difficult.

The economic reality—substantial embedded gains, aging buildings, and divergent owner preferences—produces a powerful ‘lock in’ effect. Owners are tax motivated to stay put, even where redevelopment would be the highest and best use of the property or eventually yield gains that out .

Section 1031: Not the Quick Fix It Appears to Be

When a potential sale would trigger significant capital gains, the natural instinct is to reach for [Section 1031](#) like kind exchanges. While 1031 is a powerful tool, it is a poor fit for most condo redevelopment scenarios.

Under [Section 1031](#), both the relinquished and replacement properties must satisfy a use requirement. Only to properties held for investment or for use in a trade or business qualify and personal residences do not qualify. In a typical condo building, some units are primary homes, others are vacation properties, and others are rentals—creating an immediate eligibility divide among neighbors.

In addition, [Section 1031](#) has rigid timelines. To qualify, taxpayers must identify replacement property within 45 days of disposition, and close on it within 180 days. Although there are options that might allow the parties more a flexible timelines, a six-month timeframe is not realistic for designing, entitling, financing, and constructing a new condominium project.

Finally, the division between the owners between those who qualify for [Section 1031](#) and those who don't increases the likelihood of factional politics derailing the project. Some owners could qualify for a 1031 exchange, while others will face a potentially significant tax bill. No aligned structure emerges, and developers have little appetite to negotiate separately with each faction.

***4** Ironically, the clearest path to tax deferral sometimes arises when conditions are at their worst. If a development deteriorates so severely that the local government condemns it, [Section 1033](#) may allow owners to defer gain by reinvesting in replacement property within the prescribed three year period. But condemnation is a legal taking, administered owner by owner, and can be a politically sensitive topic. It does nothing to coordinate the HOA, and the attendant litigation and valuation disputes can be lengthy and draining.

Section 121: Same Story, Different Problems

Home owners often look to [Section 121](#)'s primary residence exclusion for relief. While helpful in many ordinary home sale scenarios, the same disparate result that arose under [Section 1031](#) will limit the utility of Section 121 in the condo redevelopment context.

[Section 121](#) applies only if the unit is the taxpayer's principal residence for at least two of the five years preceding the sale. This eliminates pure vacation homes and investment rentals. In addition, the exclusion is capped at \$250,000 of gain for single filers, or \$500,000 for certain married couples filing jointly. In high-value markets or where decades of appreciation have accrued, those caps often leave significant gain exposed. Finally, for periods of ‘nonqualified use’ after January 1, 2009 (for example, when the property is rented out or used as a second home), a pro rata portion of the gain is fully taxable. That can substantially erode the benefit of [Section 121](#) for long held units with mixed personal and rental use.

As with [Section 1031](#), [Section 121](#) tends to push owners into different tax categories, encouraging conflicting strategies rather than a unified redevelopment plan.

Tax Partnerships: A Viable Alternative?

A more promising approach is to centralize the project in a tax partnership, typically an LLC taxed as a partnership. In addition to allowing the planning, financing, and management of the project to be effectively coordinated, a tax partnership holds out the promise of predictable results, and maybe even deferral.

Conceptually, in a simplified development partnership each condo owner contributes their unit and their undivided interest in the underlying land and associated common elements to an LLC. A developer receives a profits interest in the LLC in exchange for managing the redevelopment. The LLC becomes the single point of contact for financing, construction, and future sales of additional units. The LLC will finance the project, contract with third parties. It will also carry on the work of redeveloping the project, demolishing the existing building, constructing new units, selling excess units to third parties, and ultimately distributes newly built replacement units back to the contributing owners.

Tax advantages going in.

Under [Section 721](#), contributing property to an LLC taxed as a partnership in exchange for an interest in that partnership is generally a nonrecognition event. There is no immediate gain triggered on contribution, each owner's basis in the contributed property carries over to their partnership interest, and the transferors' holding periods also carry over. This allows owners to 'pool' their interests without first recognizing the built in gain that would arise on a straight sale.

Dealer income.

***5** Once the LLC is operating, a central concern is whether the partnership will be treated as a 'dealer' in real estate. If the LLC is treated as holding property primarily for sale to customers in the ordinary course of business gains from selling the extra units will be taxed as ordinary income, not capital gain. Given that ordinary income is typically taxed at higher rates than long term capital gains, this recharacterization can materially reduce the economics of the project. However, because much of the recognized income will be allocated to the developer, who in all events would have had ordinary income, the downside of recharacterization is negligible.

The hard part: getting owners back out.

Exiting the partnership cleanly is far more complicated. Partnership tax provisions are designed to prevent taxpayers from using partnerships as vehicles to effect a tax deferred exchange property where they would not otherwise be available.

Several complex partnership tax provisions are relevant in this scenario. First, the disguised sale rules under [Section 707](#) provide that if a partner contributes property and receives a distribution of cash or other property, generally within a two-year period, the IRS can treat the contribution as a taxable sale, not a contribution followed by a distribution. In a redevelopment context, any significant cash distributions around the time of contribution or redevelopment must be handled with extreme caution, including assumptions of liabilities associated with contributed property.

Second, the mixing-bowl rules under [Section 737](#) provide that if a partner contributes appreciated property to a partnership and, within seven years, receives a distribution of different property, the partner will be required to recognize the built in gain that existed at the time of contribution. In this context, significant questions and risk arise around whether the contributed unit and the newly constructed unit property are the same property. If an owner contributes an old condo unit and receives a newly built, but not 'the same' unit back within that seven year window, [Section 737](#) can trigger recognition of their original, deferred gain.

In addition, shifts in hot asset rules under [Section 751](#) and allocations of partnership liabilities under [Section 752](#), can result in unexpected gain. 'Hot assets' include items like unrealized receivables and depreciation recapture. If the rebuilt project includes depreciable property (e.g., new rental units) and distributions are not carefully structured, some portion of what would otherwise be capital gain can be converted into ordinary income under [Section 751](#). Likewise, partnership liabilities are treated as part of a

partner's basis. If a partner's share of partnership debt decreases—say, as loans are refinanced or paid down—that decrease can be treated as a deemed cash distribution. If that deemed distribution exceeds the partner's outside basis, [Section 731](#) requires immediate gain recognition.

***6** To minimize these risks, a carefully designed plan must address the treatment of the replacement units and allocations of income associated with sale of extra units, as well as managing partnership liabilities and any interim cash flows. This is not a standard real estate joint venture; it is a highly structured tax driven partnership with strict timing and allocation constraints.

The Cost of Getting It Wrong, The Benefits of Getting it Right

The consequences of missteps in this area are potentially severe. The first and most obvious result will be the realization of phantom income by the unit-holders. A large tax bill without any cash to pay it is an unwelcoming prospect for most taxpayers. The complexity of Subchapter K and the limitations of the other available deferral provisions means there are numerous opportunities for foot faults and unforced errors.

Despite the daunting complexity, modernizing a crumbling condominium project can be an attractive opportunity, a carefully redevelopment partnership can potentially limit the amount of gain recognized by unit-holders and facilitate the improvement and enjoyment of an investment. The partnership structure can allow the centralized financing and management of a condo redevelopment project that might not otherwise be feasible.

The stakes are high. With the right structure and patience, owners can unlock the value of prime locations and secure modern, resilient housing. Without that care, they risk turning a much needed redevelopment into a devastating tax event.

Footnotes

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