Like-Kind Exchange Corner

By Mary B. Foster

The Same Taxpayer Requirement of Code Secs. 1031 and 1033: Part II—Estates and Trusts

Introduction

In the November-December 2009 edition of the JOURNAL OF PASSTHROUGH ENTITIES, I discussed the same taxpayer requirement under Code Secs. 1031 and 1033.[1] This requirement provides that the taxpayer who disposed of the relinquished property in an exchange under Code Sec. 1031, or the converted property in an involuntary conversion under Code Sec. 1033 (referred to as the "relinquished property" in this column) must acquire the new property (referred to as the "replacement property" in this column) to qualify for the gain deferral. If another taxpayer acquires the replacement property, the exchange or involuntary conversion will not be eligible for nonrecognition of gain treatment under these Code provisions. In the previous column, I discussed the same taxpayer requirement for married individuals, including disregarded entities formed by the married individuals. In this submission, I examine what happens when an individual taxpayer dies prior to acquiring replacement property, as well as revocable and irrevocable trusts.

Taxpayer's Estate as a Separate Taxpayer

The IRS initially took the position that if the taxpayer died during the replacement period of a Code Sec. 1033 involuntary conversion, the taxpayer's estate could not acquire replacement property to defer the gain.[2] However, the courts rejected the IRS's position.[3] The IRS has since appeared to acquiesce to these judicial decisions.[4]

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In the Code Sec. 1031 context, the IRS issued an exceedingly taxpayer favorable private letter ruling in 1998. The taxpayer died after he and his wife disposed of two relinquished properties owned by their grantor trust. The trust acquired the replacement properties after his death. The ruling first held that the exchange qualified for nonrecognition under Code Sec. 1031.[5] Surprisingly, the ruling then stated that the taxpayer was treated as owning his half of the replacement properties at the time of his death, and, therefore, his share of the replacement properties received a stepped up basis to their fair market value under Code Sec. 1014(a), and his wife's community property share of the replacement properties received a stepped up basis under Code Sec. 1014(b)(6). Further, the ruling held that taxpayer also did not have income with respect to a decedent under Code Sec. 691 with respect to the exchange proceeds because the exchange qualified for nonrecognition.

There is no similar ruling under Code Sec. 1033 with respect to the step up in basis for the replacement property under Code Sec. 1041(a). The courts have declined to rule on the step-up-in-basis issue when they have addressed the ability of the taxpayer's estate to defer the gain under Code Sec. 1033.[6] The 1998 private letter ruling discussed above under Code Sec. 1031 did not offer much analysis and did not discuss case law under Code Sec. 1033.[7] Presumably, the IRS would reach the same conclusion under Code Sec. 1033. However, the replacement period for a Code Sec. 1033 disposition is significantly longer than the exchange period under Code Sec. 1031 and could extend several years beyond the due date for the tax return for the year of the involuntary conversion of the relinquished property. Alternatively, a Code Sec. 1031 exchange must be completed by the time of the filing of the tax return for the year of the disposition of the relinquished property. Thus, the replacement property in an exchange is likely to be acquired closer to the time of death than with an involuntary conversion. Also, Code Sec. 1031 is based on the concept of an exchange of property for property, with no constructive receipt of the funds by the taxpayer. Under Code Sec. 1033, the taxpayer can receive actual cash proceeds and reinvest the proceeds through a purchase of replacement property.

What if the estate does not complete the exchange under Code Sec. 1031 or replacement under Code Sec. 1033? Based on the Code Sec. 1031 private letter ruling, it can be surmised that the disposition of the relinquished property likely would be taxable to the taxpayer on his or her final income tax return.[8] Alternatively, for a Code Sec. 1031 exchange, the exchange proceeds could be income with respect to a decedent under Code Sec. 691(a)(4). The regulations relating to installment sales and deferred exchanges treat a deferred exchange in which replacement property is not acquired as an installment sale with the exchange proceeds being taxed when received by the taxpayer.[9] If the same rationale applies, the exchange proceeds received by the estate or testamentary trust would be taxed as income with respect to a decedent as the receipt of proceeds from an installment sale, rather than as sale proceeds from a disposition by the taxpayer prior to his or her death.

Note that the property must be acquired in the name of the estate or testamentary trust, acting on behalf of the taxpayer, and not the heirs. In one case, the widow of a deceased taxpayer was not allowed nonrecognition under Code Sec. 1033 when she acquired the replacement property in her own name and not as personal representative or trustee under the taxpayer's will or trust. The court found that she was not acting on behalf of the decedent taxpayer.[10]

Trusts as a Separate Taxpayer from the Grantor

Grantor Trusts

A taxpayer may desire to acquire his or her replacement property in a grantor trust, such as a revocable living trust, for estate planning reasons. Alternatively, the taxpayer who has held his or her relinquished property in a grantor trust may desire to hold the replacement property outside the trust, or the replacement property lender may require that title to the replacement property be held individually. Either of these changes in ownership will not disallow exchange treatment under Code Sec. 1031. Grantor trusts under Code Secs. 671–678 are not considered separate entities for federal tax purposes. With a revocable living trust, the taxpayer usually will use his or her own tax identification number and not file a separate tax return for the trust. The grantor, not the trust, is the "taxpayer" for purposes of Code Sec. 1031.[11] A taxpayer also may transfer the relinquished property to a grantor trust immediately prior to the exchange, or transfer the replacement property to a grantor trust immediately after the exchange.[12] The taxpayer should avoid terminating grantor trust status during or immediately before or after the exchange because such termination results in a transfer to a new taxpayer.[13]

Non-Grantor Trusts

Unlike grantor trusts, non-grantor trusts are separate taxpayers. Therefore, if a non-grantor trust owns the relinquished property, it must acquire the replacement property. The beneficiaries of the trust cannot acquire the replacement property in their names.

Often, the beneficiaries of a testamentary trust will want to terminate the trust and acquire the replacement property individually. This is analogous to a partnership situation in which the partners want to go their separate ways. Also, the trust may be terminating under its terms during the exchange. The IRS has issued several private letter rulings involving a testamentary trust that was terminating in accordance with its terms. The trust held many properties and had a history of conducting tax-deferred exchanges. The trust wanted to make a terminating distribution of replacement property the trust had just received. The IRS ruled this distribution would not preclude the replacement property from being held by the trust for productive use in a trade or business or for investment.[14] The IRS issued a similar ruling for property acquired by the trust as replacement property in a Code Sec. 1033 involuntary conversion immediately prior to the trust termination.[15] The IRS reasoned that these transactions were not prearranged or voluntary because the trust was terminating involuntarily and in accordance with the terms of the trust document, and as approved by the probate court. These transactions were wholly independent from the termination of trust. Notably, the IRS did not issue any rulings on any transactions that straddled the trust termination such that the trust disposed of the relinquished property and the beneficiaries acquired the replacement property, most likely because such a transaction would violate the same taxpayer requirement.

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Land Trusts

The IRS has ruled that an interest in a land trust, such as one created under Illinois law, will be considered an interest in the real property held by the land trust for the purposes of Code Sec. 1031 and not an interest in personal property or a beneficial interest in the trust.[16] Therefore, a taxpayer could dispose of real property as an individual and acquire the replacement property in a land trust. The land trust agreement in the ruling provided that the taxpayer, as beneficiary, retained exclusive control of the management, operation, renting and selling of the real property although legal title was held by the trustee. The taxpayer also was required to file all tax returns, pay all taxes and satisfy all other liabilities with respect to the real property. Based on this, the IRS reasoned that the trustee's sole responsibility of holding legal title to the real property at the direction of the taxpayer did not give rise to a trust relationship for federal tax purposes.

This ruling also applies to land trusts created under the laws of other states such as California, Florida, Hawaii, Indiana, North Dakota and Virginia, provided that: (1) the trustee has title to real property; (2) the beneficiary (or a designee of the beneficiary) has the exclusive right to direct or control the trustee in dealing with the title to the property; and (3) the beneficiary has the exclusive control of the management of the property, the exclusive right to earnings and proceeds from the property, and the obligation to pay any taxes and liabilities relating to the property.

The ruling also notes that there were no other agreements between the taxpayer and other persons that could cause the overall arrangement to be classified as a partnership. Some land trusts could be reclassified as partnerships for tax purposes and, thus, transfers of interests in these land trusts would not be eligible for Code Sec. 1031 or Code Sec. 1033 treatment. For example, a land trust could be recharacterized as a partnership if the land trust has multiple beneficiaries and an agreement between the beneficiaries that contains provisions similar to a partnership agreement.[17] Presumably, the factors that distinguish between a tenancy-in-common and a partnership for tax purposes also would apply in characterizing a land trust with multiple beneficiaries, and Rev. Rul. 2002-22 should be examined.[18]

Delaware Statutory Trusts

Like a land trust, a beneficial interest in a Delaware statutory trust (DST) may be considered an interest in the real property held by the DST. Therefore, a taxpayer can dispose of the relinquished property as an individual or entity, and acquire the replacement property in a DST. In Rev. Rul. 2004-86,[19] the DST held real property and multiple persons held beneficial interests in the DST. The trustee's duties were limited to the collection and distribution of income to the beneficial owners. Therefore, the beneficial interests in the DST represented interests in a grantor trust and the beneficial owners were considered to own undivided fractional interests in the real property for federal tax purposes. The trustee could not exchange the property for other property, purchase non-real estate assets other than short-term investment assets, or accept additional contributions of assets. The trustee also could not renegotiate the terms of the debt used to acquire the property, renegotiate the lease with the tenant of the property or enter into new leases, except in the case of bankruptcy. Further, the trustee could only make minor nonstructural modifications to the property. If the trustee had any of these additional powers, then the ruling holds that the DST would be a business entity classified as a partnership or corporation. This, of course, would make the DST a separate taxpayer from the taxpayer and would violate the same taxpayer requirement.

Like a land trust, a DST with multiple beneficiaries must avoid partnership characterization and Rev. Rul. 2002-22 should be examined.[20]

Conclusion

The same taxpayer requirement of Code Secs. 1031 and 1033 is relaxed for taxpayers and their estates. Grantor trusts are not separate taxpayers and, thus, the taxpayer can move property in or out of a grantor trust with no affect on the transaction. This is not true for non-grantor trusts. Also, grantor trust vehicles such as land trusts and DSTs must be careful to abide by the rulings discussed above and to avoid partnership-type provisions in their trust agreements if there are multiple beneficiaries.

Endnotes

1 Mary B. Foster, Like-Kind Exchange Corner, *The Same Taxpayer Requirement of Code Secs. 1031 and 1033*, J. PASSTHROUGH ENTITIES, Nov.–Dec. 2009, at 19.

2 Rev. Rul. 64-121, 1964-1 CB (Part 1) 451; *I. Goodman Est.,* CA-3, 52-2 USTC ¶9556, 199 F2d 895.

3 *J.E. Morris Est.*, 55 TC 636, Dec. 30,609 (1971); *C.H. Chichester*, DC-AL, 78-1 USTC ¶9458; *H.A. Gregg Est.*, 69 TC 468, Dec. 34,784 (1977).

4 FSA 200117005 (Jan. 12, 2001).

5 LTR 9829025 (Apr. 17, 1998).

6 *Morris Est.*, *supra* note 3; *C.H. Chichester*, *supra* note 3.

7 *Supra* note 4.

8 *Supra* note 4.

9 Reg. §1.1031(k)-1(j)(2).

10 *G.W. Jayne Est.*, 61 TC 744, Dec. 32,497 (1974).

11 Rev. Rul. 92-105, 1992-2 CB 204; Rev. Rul. 70-376, 1970-2 CB 164; Rev. Rul. 88-103, 1988-2 CB 304; Rev. Rul. 2004-86, IRB 2004-33, 191, 2004-2 CB 191.

12 LTR 9116009 (Jan. 15, 1991); Rev. Rul. 2004-86, IRB 2004-33, 191, 2004-2 CB 191.

13 LTRs 7943152 (Jul. 30, 1979); LTR 9116009 (Jan. 15, 1991).

14 LTR 200521002 (Feb. 24, 2005).

15 LTR 200528011 (Apr. 13, 2005).

16 Rev. Rul. 92-105, 1992-2 CB 204.

17 LTR 8113078 (Dec. 31, 1980); LTR 8346089 (Aug. 18, 1983).

18 Rev. Proc. 2002-22, 2002-1 CB 733, contains a list of 15 factors necessary to obtain a private letter ruling that a tenancy-in-common is not a partnership for federal tax purposes.

19 Rev. Rul. 2004-86, IRB 2004-33, 191, 2004-2 CB 191.

20 *See supra* note 18.