Like-Kind Exchange Corner

By Mary B. Foster

The Same Taxpayer Requirement of Code Secs. 1031 and 1033

Introduction

The same taxpayer that 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 article) must acquire the new property (referred to as the replacement property in this article) to qualify for the gain deferral. Code Sec. 1031(a)(3) provides that replacement property received by the "taxpayer" will not be like-kind unless identified within 45 days of the date on which the "taxpayer" transfers the relinquished property in the exchange and received within 180 days after the date on which the "taxpayer" transfers the relinquished property in the exchange.[1] Likewise, Code Sec.1033(a)(2)(A), provides that the "taxpayer" must purchase the replacement property during the period specified in Code Sec. 1033 for the purpose of replacing the converted property.[2]

Consequently, 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, although a few limited exceptions do exist. This column examines the same taxpayer requirement for married individuals, including disregarded entities formed by the married individuals to acquire the replacement property. I will examine the same taxpayer requirement for the taxpayer's estate, trusts, partnerships and corporations in subsequent articles.

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The Other Spouse as a Separate Taxpayer

If the relinquished property is held by a husband and wife as marital property, including community property, then each spouse is presumed to be a separate taxpayer and to own one-half of the relinquished property, and the replacement property also should be acquired in equal shares. In a 1982 private letter ruling, a husband and wife held involuntarily converted real property as tenants in the entirety. However, the replacement property was acquired solely in the husband's name and the wife's name was not on the deed. The IRS ruled that the wife had gifted her 50 percent of the proceeds from the conversion to her husband, and she did not acquire replacement property. Thus, she had to report 50 percent of the gain on the sale of the property.[3]

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Similarly, if the relinquished property is held as a spouse's separate property under the applicable state law, the replacement property also should be held as his or her separate property. This may not please the other spouse who was expecting to be added to title to the replacement property. However, a tax-free gift of the one-half of the replacement property can be made to the other spouse or to the marital community later under Code Sec. 1041, but it should not be done until after the exchange is "old and cold."[4]

Note that the 1982 private letter ruling discussed above was issued prior to the 1984 enactment of Code Sec. 1041. Code Sec. 1041(b) provides that transfers between spouses are treated as tax-free gifts. It does not appear to contradict the IRS's reasoning in the 1982 private letter ruling, and it would be dangerous to assume that the IRS would reach a different result today because of the enactment of Code Sec. 1041.

If the relinquished property is held as the separate property of one spouse, the other spouse can also invest in the replacement property to the extent the value of the replacement property exceeds the value of the relinquished property. For example, if the wife disposed of relinquished property valued at $500,000 and the replacement property will cost $750,000, the replacement property could be acquired by the spouses as tenants-in-common, with two-thirds acquired by the wife as her replacement property and one-third acquired by the husband as a new purchase.

Spousal LLCs as the Same or Separate Taxpayers

Many spouses who owned the relinquished property as marital or community property in their individual names want to acquire the replacement property in a limited liability company (LLC) to add a layer of liability protection. Or perhaps, the lender on the replacement property requires a bankruptcy remote entity, such as an LLC, to acquire title. In this situation, married individuals who will acquire the replacement property as community property receive different and more favorable tax treatment than married individuals who will acquire the replacement property as non-community property.

Community Property

The IRS, in Rev. Proc. 2002-69, ruled that an LLC owned solely by a husband and wife as community property under the laws of a state can be considered a sole proprietorship and disregarded entity for federal tax purposes, even though the LLC has two members.[5] Thus, the husband and wife can dispose of the relinquished property in their individual names, and acquire the replacement property in one LLC.[6] However, they both must hold their membership interests in the LLC as community property, and they cannot elect partnership or corporate tax status for the LLC. This ruling also applies to foreign countries or possessions of the United States that have community property laws.

The nine community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin.[7] The laws of the community property states can vary on the characterization of community property, and the law of the particular state should be consulted to determine what constitutes community property for the residents of that state. To avoid any ambiguity as to community property status, the operating agreement of the

LLC should affirmatively state that the membership interests are community property and not separate property of the spouses.

Non-Community Property States

Rev. Proc. 2002-69 only applies to LLCs owned by the husband and wife as community property and not to married individuals who are domiciled in non-community property or common law states. If the spouses in a non-community property state own the relinquished property individually, they cannot simply take title to the replacement property in one LLC with the spouses as the only members. This is true even if they file their IRS Form 1040 tax return jointly. The LLC would be considered a partnership and, therefore, a different taxpayer than the married individuals who disposed of the relinquished property.[8] Accordingly, there would be no nonrecognition of gain under Code Secs. 1031 or 1033.

This creates a problem for married individuals domiciled in non-community property states, if they want or need to acquire the replacement property in a LLC. They cannot solve the problem by simply holding their membership interests in the LLC in a tenancy-by-the-entirety or as joint tenants. While these forms of ownership may be similar to community property, they are still not covered by Rev. Proc. 2002-69, which is clearly limited to community property. Likewise, married individuals cannot solve this problem by placing the LLC interests in a single revocable living trust with the husband and wife as grantors. A grantor trust is not a separate taxpayer for these purposes.[9] Therefore, the tax owners of the LLC would be the husband and wife, individually, and the LLC would be a partnership for federal tax purposes. Some married individuals also erroneously believe they can form one LLC that will qualify as a disregarded entity because they file their IRS Form 1040 jointly.

What options do these married individuals have, if they want or need to take title to the replacement property in a LLC?

Co-Tenancy of Two Single-Member LLCs. Each spouse can form his or her own single-member LLC and the LLCs can hold title to replacement property as 50/50 co-owners. The spouses can then continue to report the ownership of the replacement property on their joint IRS Form 1040 tax return.[10] Unfortunately, this results in a doubling of not only the state LLC filing fees, but also the registered agent fees and annual LLC maintenance fees. It also is confounding to individuals who do not regularly deal with the complexities of business entities and federal tax laws.

Qualified Joint Venture. Code Sec. 761(f) provides that a husband and wife in a "qualified joint venture" (QJV) will not have to file tax returns as a partnership. This provision would allow the husband and wife to form an LLC and still report the activity on their IRS Form 1040 rather than an IRS Form 1065. Thus, the QJV would be the same taxpayer as the husband and wife for the purposes of the Code Secs. 1031 and 1033. To be a QJV, the husband and wife must file a joint return for the tax year, elect to have Code Sec. 761(f) apply, and be the only members in the QJV. In addition, both spouses must "materially participate" in the business and each spouse must meet this material participation test separately without attribution for the other spouse's activities.[11] "Material participation" is defined under the Code Sec. 469 passive activity rules as being involved in the operation of the activity on a regular, continuous and substantial basis.[12] The regulations to the passive loss rules in Code Sec. 469 provide several alternative tests for "material participation" that could apply to rental real estate owners or other property owners doing an exchange under Code Sec. 1031 or replacing converted property under Code Sec. 1033.[13] However, these tests require substantial activities that may be difficult for many taxpayers to meet with rental real estate. For example, one test would require the husband and wife to each participate more than 500 hours in the activity for the tax year.

The instructions to IRS Form 1040 for the QJV require that each spouse must file a separate Schedule C for rental real estate instead of Schedule E. Schedule C requires that the income from the business be shown on Schedule SE and the taxpayer must pay self-employment taxes on it. Real estate rental income is not otherwise subject to self-employment taxes if it is reported on Schedule E, so this potentially creates an additional tax that would not be owed without the election for the QJV. However, the IRS has issued a legal memo stating that the purpose of Code Sec. 761(f) was not to convert real estate rental income into income that is subject to self-employment tax. The IRS memo thus states that "in the case of a husband and wife who make the QJV election for a rental real estate business, each spouse has a share of the QJV income, and each spouse may exclude his or her respective share of the QJV income from [self-employment income]."[14]

Conclusion

Married individuals have special issues when acquiring replacement property in a Code Sec. 1031 exchange or a Code Sec. 1033 involuntary conversion. If they own the relinquished property as marital or community property, they are presumed to each own one-half of the relinquished property and they must acquire the replacement property in the same ratio to defer all of the gain. Likewise, if one spouse owns the relinquished property as his or her separate property, that spouse must acquire an equal amount of the replacement property. Finally, married individuals in community property states may take advantage of Rev. Proc. 2002-69 by using a disregarded entity such as an LLC to acquire the replacement property. Those married individuals in non-community property states will have to rely on the more costly methods discussed above.

Endnotes

[1] *See also D.G. Chase*, 92 TC 874, Dec. 45,634 (1989).

[2] *See Vim Securities Corp.*, CA-2, 42-2 USTC ¶9602, 130 F2d 106; TAM 9227002 (Feb. 27, 1992).

[3] LTR 8429004 (Mar. 22, 1984).

[4] D.H. Click, 78 TC 225, Dec. 38,790 (1982).

[5] Rev. Proc. 2002-69, IRB 2002-45, 831; 2002-2 CB 831.

[6] See LTR 200732012 (May 11, 2007).

[7] *See* IRS Publication 555, *Community Property*.

[8] For example, the instructions to IRS Form 1065, *U.S. Return of Partnership Income*, provide that if a husband and wife jointly own and operate an unincorporated business, they are partners and must file an IRS Form 1065.

[9] 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.

[10] LTR 9807013 (Nov. 13, 1997).

[11] Code Sec. 761(f)(2)(B).

[12] Code Sec. 469(h).

[13] Temporary Reg. §1.469-5T.

[14] CCA 200816030 (Mar. 18, 2008).