Connecting the Dots

1031 Exchanges and Tax Ownership

1031 Knowledge

A common, but often misunderstood, principle among those familiar with tax-deferred exchanges under Internal Revenue Code Section 1031 is the notion that the vesting of the replacement property acquired in the exchange must match the vesting of the property sold by the taxpayer. In other words, if title to the property relinquished in the exchange is in a corporation, then title to the replacement property must be acquired by the same corporation. Although the foregoing statement may be true in many cases, it is merely a guideline for structuring an exchange. What is required to complete an otherwise valid 1031 exchange is that the "tax owner" of the relinquished property must acquire tax ownership of replacement property within the exchange period permitted under §1031. Fortunately, there are many ways to acquire tax ownership of property that can involve the use of certain business entities or trusts which are disregarded for federal income tax purposes. Through the use of these entities in a tax-deferred exchange, a wide variety of structuring opportunities become available, some of which can address a taxpayer's other investment goals, such as limited liability and succession planning. In these cases, the vesting of the relinquished property may be very different than the vesting of the replacement property, although tax ownership of the replacement property is the same both before and after the exchange.

To make sense of the proposition set forth above, it is necessary to distinguish between: (i) federal tax ownership, (ii) state law ownership, and (iii) vesting. In any given case, all three indicators of ownership might match up, such as an individual who holds title to investment property as "John Smith, an unmarried man." But even in this simple case, Mr. Smith might not actually own the property to which he holds title under state law or federal tax law. For example, many states recognize nominee arrangements under which Mr. Smith might hold title for the benefit of another person who actually owns the property. If there were such a nominee arrangement, Mr. Smith would be the record title holder, but not the tax owner or the state law owner of the property. If Mr. Smith sells property that he holds as nominee for Mr. Saunders, then the gain on the sale would be reported by Mr. Saunders.

Similarly, if title to the property is held in the ABC limited liability company (ABC LLC), we know what vesting should look like and that the state law ownership rests in the limited liability company, but who is the tax owner? The answer depends on how ABC LLC is characterized for federal income tax purposes. If the company has elected to be taxed as a corporation, then tax ownership would be in the company. If the limited liability company has more than one member and has not elected to be treated as a corporation for tax purposes, then it is treated as a partnership for federal income tax purposes and, again, the company is the tax owner of the property. If, however, Mr. Smith is the sole member of ABC LLC and the company has not elected to be treated as a corporation for federal tax purposes, then Mr. Smith is the owner of the property for federal income tax purposes. Under federal tax law, a single member limited liability

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company is a "disregarded entity" and its assets are treated as being owned by the sole member of the company. Thus, if Mr. Smith sells property in a 1031 exchange (property which was titled in his name), he could acquire property in ABC LLC provided he is the sole member and the company is a disregarded entity. The same result would follow where ABC LLC sells relinquished property and Mr. Smith acquired replacement property in his individual name.

Revocable trusts are another area where tax ownership, state ownership, and vesting may diverge. During the lifetime of the person who forms a revocable trust (a Grantor) and during the time he or she retains the right to revoke the trust, federal law treats the Grantor as the tax owner of assets held in the trust. So, as the Grantor, Mr. Smith is the tax owner of assets held in his revocable trust, but the trust is treated as an entity under state law and for purposes of vesting and ownership of trust property. Thus, Mr. Smith might sell property owned by his revocable trust as part of a 1031 exchange and acquire replacement property in his own name. Alternatively, if Mr. Smith sells property owned by his trust, he could also acquire replacement property in a disregarded limited liability company in which he was the sole member, or, he could acquire replacement property in a disregarded limited liability company owned solely by Mr. Smith's revocable trust.

In most of the foregoing examples, a valid 1031 exchange can be accomplished in circumstances where the vesting of the relinquished property does not match the vesting of the replacement property. Thus, the notion that vesting of the relinquished property and the replacement property must be the same is not a hard and fast rule. What matters is that the tax owner of the relinquished property acquires tax ownership of the replacement property.

The determination of tax ownership is not always a simple matter, especially for those not steeped in federal tax law. Accountants and tax attorneys can assist in structuring an exchange transaction to maximize the taxpayer's advantage. In the last example, in the preceding paragraph in which Mr. Smith relinquishes property owned in his revocable trust and acquires replacement property in a disregarded limited liability company owned solely by Mr. Smith's revocable trust, Mr. Smith not only obtained tax deferral under §1031, he obtained limited liability under state law that would protect the trust and himself from liabilities which may arise out of his ownership and operation of the property. He also ensured that the property was properly held in his trust to be disposed of in accordance with his overall estate plan.

Asset Preservation, Inc., encourages clients to obtain competent tax and/or legal advice in structuring a 1031exchange transaction. Because of the non-tax considerations surrounding the structure of an exchange transaction (such as limited liability, liability protection, and succession planning), many taxpayers would benefit by consulting their personal tax and/or legal advisors before engaging in a 1031 exchange transaction.

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