



USING DISREGARDED ENTITIES IN A LIKE-KIND EXCHANGE

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Basic Rule. While not specifically stated in IRC 1031 a basic rule when doing a like kind exchange is that there must be continuity of title. This is often called the “same taxpayer rule”. It means that title to the interest in the property being purchased, the replacement property, must be the same as the name of the party or entity holding title to the property being sold, the relinquished property. Of course with any rule there are exceptions. The three exceptions pertaining to the transfer and receipt of exchange property are 1) revocable living trusts, 2) a single member limited liability company (LLC), and 3) a Delaware Statutory Trust. These are all considered by the IRS as disregarded entities.

What is a Disregarded Entity? A disregarded entity is a separate legal entity which creates limited liability for its owner. However, for tax purposes it is treated as if it were part of its owners activity. If the taxpayer’s investment, business or rental property is held in the name of a disregarded entity using the same tax identification number, then only a single Schedule E or Schedule C tax return needs to be filed.

Revocable Living Trust or Grantor Trust. For estate planning purposes a taxpayer may wish to take title to the replacement property in the name of his, her, or their revocable living trust. Or they may hold the relinquished property in a revocable living trust or other grantor trust and wish to hold the replacement property outside the trust. In either case, exchange tax deferral under IRC Section 1031 will be permitted. The trust is a disregarded entity and the taxpayer will file a single return using his own tax identification number, and not file a separate return for the trust.

If a husband and wife have a separate revocable living trust, then they will need to hold title to the replacement property in the name of their own separate revocable living trust. The real estate purchase contract and instructions to the settlement attorney need to be clear as to how title will be held.

Single Member LLC. To reduce their liability many property owners desire to hold title in the name of a limited liability company (LLC). In an exchange situation the IRS has ruled that a **single member** LLC will be a disregarded entity. Thus, if an individual holds title to the relinquished property in his or her own name, they may purchase and hold title to the replacement property in the name of a single member LLC that does not elect to be taxed as an association (see IRS Form 8832 and Instructions).

If, in a non-community property state, a husband and wife hold the relinquished property jointly but wish to hold the replacement property in an LLC, they must form two separate single member LLCs. In the nine community property states of Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin, a husband and wife may have a two member LLC which will be considered a disregarded entity for federal tax purposes.

Delaware Statutory Trust. The third exception to the rule is the use of a Delaware Statutory Trust. The IRS recently issued Revenue Ruling 2004-86 which states that under certain

circumstances a Delaware Statutory Trust will be treated as a disregarded entity for federal income tax purposes. The beneficial owners of a Delaware Statutory Trust are provided the same liability protection as shareholders in a Delaware corporation. If the specific rules in the Revenue Ruling are followed, a taxpayer may exchange real property for an interest in the Delaware Statutory Trust. This change is of particular importance to sponsors and purchasers of tenant-in-common (TIC) exchange properties.

Other Issues. If the relinquished property is held jointly by the husband and wife, then the replacement property should be held in the same manner. If the relinquished property is held as a spouse's separate property, the replacement property should also be held as his or her separate property. A tax free gift of an interest in the replacement property can be made to the other spouse after the exchange is completed.

Often lenders or state law require both spouses to be on title even though the relinquished property was held as the separate property of only one spouse. Mary Foster, Esq., CES®, author of *Tax Free Exchanges Under §1031* suggests in such cases, to avoid IRS problems in a future audit, that the "spouses should have a written agreement that the co-signing spouse is doing so in trust for the other spouse and the character of the replacement property is separate property of the other spouse and no gift has occurred."

Keep the QI Advised. If the name on the title of the relinquished property is different from that to be used on the replacement property it is essential that the qualified intermediary and settlement agent/attorney be aware of this change. In some cases the change may not be permissible under Section 1031 rules. If a disregarded entity is to be used, the exchange documentation and instructions must reflect the new entity and share of interest to be held.

It is important that a taxpayer planning to title the replacement property in the name of a different entity get the advice of their CPA and/or tax advisor to be certain the transaction will qualify under IRC Section 1031.

Check with your QI and tax advisor if the replacement property will be titled differently than the relinquished property.

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