

uses the term "property used in the trade or business" but, unlike I.R.C. § 1231, I.R.C. § 1031 does not impose a specific holding period for either the relinquished property or the replacement property in the exchange.

### § 2:41 Deferred exchanges—I.R.C. § 1031(a)(3)

I.R.C. § 1031(a)(3) provides:

(3) *Requirement that property be identified and that exchange be completed not more than 180 days after transfer of exchanged property.* For purposes of this subsection, any property received by the taxpayer shall be treated as property which is not like-kind property if:

(A) Such property is not identified as property to be received in the exchange on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange, or

(B) Such property is received after the earlier of:

(i) The day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or

(ii) The due date (determined with regard to extension) for the transferor's return of the tax imposed by this chapter for the taxable year in which the transfer of the relinquished property occurs.

In a deferred exchange, the replacement property must be identified within 45 days from the transfer of the relinquished property and acquired within 180 days after that day or the due date (with extensions) of the taxpayer's federal income tax return for the year in which the relinquished property was transferred. Both the 45-day and 180-day time periods begin on the date the relinquished property is transferred. The Regulations on deferred exchanges are analyzed later in this work.<sup>1</sup>

### § 2:42 Same taxpayer requirement

Although it is not explicitly stated in I.R.C. § 1031, the same taxpayer that disposed of the relinquished property must acquire the replacement property to satisfy the exchange requirement of I.R.C. § 1031.<sup>1</sup> I.R.C. § 1031(a)(3) provides that 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. A few exceptions to the same taxpayer rule exist, as discussed below. Under I.R.C. § 1033, the same taxpayer generally must acquire the replacement property.<sup>2</sup>

### § 2:43 Same taxpayer requirement—Spouses

If the relinquished property is held by spouses as marital property, including community property, the replacement property should also be held in the name of both spouses in equal shares. Each spouse is presumed to be a separate taxpayer and the owner of one-half of the relinquished property. In a technical advice memorandum, a husband and wife held involuntarily converted property as tenants in the entirety and the replacement property was acquired solely in the husband's name.

#### [Section 2:41]

<sup>1</sup>See §§ 6:1 et seq.

#### [Section 2:42]

<sup>1</sup>Chase v. C.I.R., 92 T.C. 874, Tax Ct. Rep. (CCH) 45634, Tax Ct. Rep. Dec. (P-H) 92.53, 1989 WL 38262 (1989).

<sup>2</sup>I.R.C. § 1033(a)(2)(A).

The IRS ruled that because the wife was not named on the deed to the replacement property, she gifted her portion of the proceeds to her husband and she must report 50% of the gain on the sale of the property.<sup>1</sup> 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 gift of the replacement property can be made later tax free under I.R.C. § 1041 after the exchange is "old and cold."<sup>2</sup>

Often, lenders on the replacement property may require both spouses to be on title and to sign on the loan even though the relinquished property was held as the separate property of the spouse. In such a case, 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. The taxpayer's spouse can acquire an interest in the replacement property if the replacement property value and equity exceed the value and equity of the relinquished property. For example, if spouse A disposed of relinquished property valued at \$750,000 and the replacement property will cost \$1,000,000, the replacement property could be acquired by both spouses as tenants-in-common, with a 75% interest acquired by spouse A as her replacement property and a 25% interest acquired by spouse B as a new purchase.

In some situations, the relinquished property may be held by the spouses as marital or community property, but they each wish to acquire their own replacement property as separate property. For example, this may occur if the couple is planning to divorce in the near future. Each spouse should be able to use one-half of the relinquished property proceeds to satisfy that spouse's exchange requirement by acquiring replacement property in that spouse's name as separate, non-marital property.

Spouses who owned the relinquished property in their individual names, as a married couple, may want to acquire the replacement property in a limited liability company to add a layer of liability protection. While this may be done easily if the replacement property is community property, it is more complicated when non-community property is involved, as discussed in § 2:47 below.

#### § 2:44 Same taxpayer requirement—Death of taxpayer

If a taxpayer dies during the exchange period, the taxpayer's estate or trustee may complete the exchange.<sup>1</sup>

The Service has taken the position that the taxpayer's estate may not acquire replacement property under I.R.C. § 1033 in an involuntary conversion.<sup>2</sup> However, the courts have rejected the Service's position.<sup>3</sup>

The widow of a deceased taxpayer, however, was not allowed nonrecognition

##### [Section 2:43]

<sup>1</sup>TAM 8429004.

<sup>2</sup>Click v. Commissioner of Internal Revenue, 78 T.C. 225, Tax Ct. Rep. (CCH) 38790, 1982 WL 11189 (1982); see § 2:16.

##### [Section 2:44]

<sup>1</sup>Ltr. Rul. 9829025; In re Goodman's Estate, 1954-1 C.B. 296, 199 F.2d 895, 52-2 U.S. Tax Cas. (CCH) P 9556, 42 A.F.T.R. (P-H) P 877 (3d Cir. 1952); Estate of Gregg v. Commissioner of Internal Revenue, 69 T.C. 468, 1977 WL 3622 (1977).

<sup>2</sup>Rev. Rul. 64-121, 1964-1 C.B. 298.

<sup>3</sup>Estate of Morris v. Commissioner of Internal Revenue, 55 T.C. 636, 1971 WL 2582 (1971), nonacquiescence recommended by, 1971 WL 29125 (I.R.S. AOD 1971) and aff'd, 454 F.2d 208, 72-1 U.S. Tax Cas. (CCH) P 9177, 29 A.F.T.R.2d 72-391 (4th Cir. 1972) and nonacq., 1978-2 C.B. 1; Chichester v. U.S., 78-1 U.S. Tax Cas. (CCH) P 9458, 42 A.F.T.R.2d 78-5139, 1978 WL 1225 (N.D. Ala. 1978).

under I.R.C. § 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.<sup>4</sup>

The deceased taxpayer's estate defers the tax and also receives a stepped up tax basis in the replacement property under I.R.C. § 1014(a). The Service ruled that when a husband and wife grantor trust acquired replacement property after the husband trustee's death, the husband trustee was treated as owning his share of the replacement property at the time of his death and did not have income with respect to a decedent under I.R.C. § 691. Further, because the relinquished property was community property, the trustee's wife also received a stepped up basis for her share of the replacement property.<sup>5</sup>

If the exchange is not completed with the acquisition of replacement property by the personal representative or testamentary trust of the taxpayer, the disposition of the relinquished property would be taxable to either the taxpayer on his or her final income tax return, or to the estate or testamentary trust as income with respect to a decedent.<sup>6</sup> 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.<sup>7</sup> 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 a sale by the taxpayer prior to his or her death.

#### § 2:45 Same taxpayer requirement—Grantor trusts

A taxpayer may want to acquire his or her replacement property in a "grantor" trust for estate planning reasons. Alternatively, a taxpayer who has held his or her relinquished property in a revocable living trust may need to acquire the replacement property outside of the trust because of lender requirements. These changes in legal ownership should not disallow exchange treatment under I.R.C. § 1031. All "revocable trusts," such as revocable living trusts, are by definition grantor trusts. If a trust is a grantor trust, then the grantor is treated as the owner of the assets for income tax purposes, the trust is disregarded as a separate income tax entity, and all income is taxed to the grantor. The taxpayer will usually use his or her tax identification number and not file a separate tax return for the trust. The IRS has ruled that the grantor of the grantor trust, not the trust, is the "taxpayer" for the purposes of I.R.C. § 1031 when the trust was revocable.<sup>1</sup> Thus, a taxpayer may transfer the relinquished property to a revocable grantor trust immediately prior to the exchange, or transfer the replacement property to a revocable grantor trust immediately after the exchange.<sup>2</sup> Care should be taken, however, to avoid terminating grantor trust status during or immediately before or after the exchange because such termination results, in effect, in a transfer to a new taxpayer.<sup>3</sup>

An "irrevocable trust" can be treated as a grantor trust if any of the grantor trust

<sup>4</sup>Estate of Jayne v. Commissioner of Internal Revenue, 61 T.C. 744, 1974 WL 2676 (1974).

<sup>5</sup>Ltr. Rul. 9829025.

<sup>6</sup>I.R.C. § 691(4); Ltr. Rul. 9829025.

<sup>7</sup>Reg. § 1.1031(k)-1(j)(2); see §§ 4:1 et seq.

#### [Section 2:45]

<sup>1</sup>Rev. Rul. 92-105, 1992-2 C.B. 204; Rev. Rul. 70-376, 1970-2 C.B. 164; Rev. Rul. 88-103, 1988-2 C.B. 304; Rev. Rul. 2004-86, 2004-33 I.R.B. 191.

<sup>2</sup>Ltr. Rul. 9116009; Rev. Rul. 2004-86, 2004-33 I.R.B. 191.

<sup>3</sup>Ltr. Ruls. 7943152, 9116009.

definitions contained in I.R.C. §§ 671 to 678 are met. An “intentionally defective grantor trust” (IDGT) is a popular estate planning device, and is generally an irrevocable trust created for the benefit of the grantor’s children and grandchildren. Transfers to the IDGT are completed for gift and estate tax purposes, but “defective” for income tax purposes because the grantor retains a minor power such as the right to substitute other property with equivalent value.<sup>4</sup> Therefore, the grantor of an IDGT is taxable on the IDGT’s income and is treated as the owner of the IDGT’s assets for federal income tax purposes. While there are rulings regarding revocable grantor trusts and I.R.C. § 1031, there are no rulings involving IDGTs and I.R.C. § 1031. However, Rev. Rul. 2004-86 regarding Delaware statutory trusts, does provide that an interest in an irrevocable grantor trust is treated as an interest in the trust property for I.R.C. § 1031 purposes. Therefore, despite the transfer of the property to the IDGT, the grantor should remain as the taxpayer for I.R.C. § 1031 purposes as the deemed owner of the IDGT’s assets.

See § 2:13 for a discussion of land trusts. See § 9:18 for a discussion of Delaware statutory trusts.

### **§ 2:46 Same taxpayer requirement—Partnerships and limited liability companies**

If a partnership is the owner of the relinquished property at the time of the exchange, then the same partnership must acquire the replacement property in the exchange.<sup>1</sup> The partners may not acquire the replacement property in their individual names as a liquidation of their partnership interests.<sup>2</sup> The partnership may want to convert from a general partnership to a limited partnership or limited liability company during the exchange period so that the replacement property is acquired in the name of the new limited partnership or limited liability company for additional liability protection for the partners. The conversion will not disallow the exchange. The IRS has stated in a private letter ruling that conversion of a limited liability company to a limited partnership during the exchange period does not affect the exchange. The successor limited partnership is treated as both the transferor of the relinquished property and transferee of the replacement property in the exchange.<sup>3</sup> This ruling is based on several Revenue Rulings that hold the conversion of a general partnership to a limited partnership, or a partnership to a limited liability company or vice versa does not cause a termination of the partnership and does not cause the partnership taxable year to close. The resulting limited partnership or limited liability company does not need to obtain a new tax identification number. These rules apply even if the limited liability company is formed in a different state than the partnership.<sup>4</sup> In these Revenue Rulings and this letter ruling, each partner’s total percentage interest in the partnership’s profits, losses, and capital remained the same after the conversion. Therefore, no partners should be admitted or withdrawn at the time of the conversion. Further, the business of the partnership continued to be carried on after the conversion. A change in the

<sup>4</sup>See Rev. Rul. 85-13, 1985-1 C.B. 184; Ltr. Rul. 200842007; CCA 201343021; but see Rothstein v. U.S., 735 F.2d 704, 84-1 U.S. Tax Cas. (CCH) P 9505, 54 A.F.T.R.2d 84-5072 (2d Cir. 1984).

#### **[Section 2:46]**

<sup>1</sup>Chase v. C.I.R., 92 T.C. 874, Tax Ct. Rep. (CCH) 45634, Tax Ct. Rep. Dec. (P-H) 92.53, 1989 WL 38262 (1989).

<sup>2</sup>TAM 9818003.

<sup>3</sup>Ltr. Rul. 99935065.

<sup>4</sup>Rev. Rul. 84-52, 1984-1 C.B. 157; Rev. Rul. 95-37, 1995-1 C.B. 130; Rev. Rul. 95-55, 1995-2 C.B. 313; Ltr. Rul. 9935065.

partners' share of liabilities as a result of the conversion may trigger gain to a partner whose share of liabilities or at risk basis is reduced.<sup>5</sup>

The ownership of the partnership may change during the exchange period provided the changes do not result in a termination under I.R.C. § 708(b)(1)(B) if 50% or more of interests in partnership capital and profits is sold or exchanged within a 12-month period. A disposition of a partnership interest by gift (including assignment to a successor in interest), bequest, or inheritance, or the liquidation of a partnership interest, is not a sale or exchange for purposes of I.R.C. § 708(b)(1)(B).<sup>6</sup> Therefore, one partner may buy another partner out provided the transferor partner does not own 50% or more of an interest in the capital and profits interest in the partnership. Likewise, a new partner may be admitted to the partnership without a termination if the new partner contributes capital or services under I.R.C. § 721.<sup>7</sup> There is no authority addressing whether or not a new partnership resulting from a replacement period termination could acquire the replacement property. Thus, partnership terminations during an exchange should be avoided. The IRS has ruled that that termination of the partnership under I.R.C. § 708(b)(1)(B) did not affect a prior exchange because the transfers of partnership interests that gave rise to the termination were essentially involuntary.<sup>8</sup> The ruling indicates that the IRS does consider a termination under I.R.C. § 708(b)(1)(B), caused by voluntary transfers of partnership interests, a violation of the qualified use requirement of I.R.C. § 1031. The IRS's position indicates that it would also conclude that a termination creates a new taxpayer for the same taxpayer requirement.

I.R.C. § 708(b)(2) also provides special rules for mergers and divisions of partnership that do not result in partnership terminations. In the case of the merger or consolidation of two or more partnerships, the resulting partnership is considered the continuing partnership of any merging or consolidating partnership whose members own more than 50% in the capital and profits of the resulting partnership.<sup>9</sup> If two or more partnerships could be the continuing partnership, then the merging partnership that contributes assets with the greatest fair market value (net of liabilities) is the continuing partnership. There can only be one continuing partnership, so the other partnerships would be considered terminated.<sup>10</sup> I.R.C. § 381 provides for the carryover of tax attributes in corporate mergers, and the IRS has ruled that a successor corporation in a nontaxable reorganization covered by I.R.C. § 381 may acquire the replacement property in an exchange when the predecessor corporation disposed of the relinquished property.<sup>11</sup> While there are no comparable rulings for partnerships, presumably, if the continuing partnership was the transferor of the relinquished property, it could complete the exchange by acquiring the replacement property. If the partnership that disposed of relinquished property prior to the merger is terminated in the merger, the exchange would most likely fail because the partnership will no longer exist and cannot acquire replacement property.

In the case of a division of a partnership into two or more partnerships, any resulting partnership is considered a continuing partnership if the resulting partnership has members who owned more than 50% in the capital and profits of the prior

<sup>5</sup>I.R.C. §§ 752, 465, Ltr. Rul. 200345007.

<sup>6</sup>Reg. § 1.708-1(b)(1)(ii); see §§ 9:1 et seq.

<sup>7</sup>Reg. § 1.708-1(b)(1)(ii). The admission of a new partner may trigger taxable gain due to debt reallocation. See § 9:16.

<sup>8</sup>Ltr. Rul. 200812012.

<sup>9</sup>I.R.C. § 708(b)(2)(A).

<sup>10</sup>Reg. § 1.708-1(c)(1).

<sup>11</sup>See Ltr. Ruls. 9751012, 200151017, 9152010.



partnership.<sup>12</sup> Any other resulting partnerships are considered new partnerships.<sup>13</sup> If the dividing partnership disposes of relinquished property prior to the division, the continuing partnerships can perhaps complete the exchange, although it is not clear how any boot would be allocated. The IRS has ruled that if the dividing partnership disposes of property in an I.R.C. § 1033 transaction and makes an election to replace the property, the continuing partnerships may acquire the replacement property.<sup>14</sup> A resulting partnership that is not a continuing partnership would most likely not be able to complete an exchange started by the divided partnership because the resulting partnership is treated as a new partnership. See Chapter 9 for a discussion of buying a partner out as replacement property in an exchange, and changes in ownership prior to and after an exchange.

#### **§ 2:47 Same taxpayer requirement—Single member limited liability companies**

Most states have laws that allow single member limited liability companies. The taxpayer can elect to have a single member limited liability company be taxed as either a sole proprietorship or a corporation for federal tax purposes.<sup>1</sup> If the taxpayer elects taxation as a sole proprietorship, then the taxpayer could hold the relinquished property as an individual and the replacement property as a single member limited liability company in an exchange. This allows the taxpayer the benefit of the liability protection of a limited liability company. It also allows the taxpayer to satisfy the "single asset entity" requirements that many lenders impose on the replacement property. The Service has approved the use of a single member limited liability company for the replacement property in an exchange. In one private letter ruling, a parent corporation and two subsidiaries each disposed of relinquished property in three exchanges. During the exchange period, the subsidiaries merged with the parent and the parent then formed three single member limited liability companies. The limited liability companies did not elect to be taxed as associations. Each limited liability company then acquired one of the three replacement properties to complete the exchange. The Service ruled that the parent company would be treated as both the transferor and the transferee for the purposes of Section 1031 and the acquisition of each replacement property by the limited liability companies would be deemed an acquisition by the taxpayer. Further, the acquisition of the replacement properties by the nonelecting limited liability companies did not violate the requirement under Section 1031(a)(1) that the replacement property "is to be held either for productive use in a trade or business or for investment."<sup>2</sup>

In another private letter ruling, the taxpayer, a limited partnership, disposed of relinquished property in an exchange.<sup>3</sup> The lender for the replacement properties required that each replacement property be held by a single asset entity. The taxpayer formed a separate "business entity" within the meaning of Reg. §§ 301.7701-2 and -3 for each replacement property (the ruling does not specify the type of entity formed, but it must be an unincorporated entity under the regulations cited). The taxpayer was the sole owner of each entity and did not elect to be taxed as an association. The Service ruled that the receipt of the replacement properties

<sup>12</sup>I.R.C. § 708(a)(b)(2)(B).

<sup>13</sup>Reg. § 1.708-1(d)(1).

<sup>14</sup>See Ltr. Rul. 200921009 and Ltr. Rul. 8244124 regarding I.R.C. § 1033.

#### **[Section 2:47]**

<sup>1</sup>Reg. §§ 301.7701-2, 301.7701-3.

<sup>2</sup>Ltr. Rul. 9751012.

<sup>3</sup>Ltr. Rul. 9807013.

by the business entities would be treated as the receipt of the replacement property by the taxpayer for the purposes of Section 1031.

In another private letter ruling, a disregarded entity of a taxpayer owned the relinquished property, and entered into the exchange agreement with the qualified intermediary.<sup>4</sup> Following the sale of the relinquished property, the disregarded entity assigned all of its rights and obligations in the exchange agreement to the taxpayer. The replacement property was then acquired by a newly created disregarded entity of the taxpayer. The ruling concludes that the actions of the disregarded entity that owned the relinquished property were attributable to the taxpayer and the acquisition of replacement property by the new disregarded entity is treated as an acquisition by the taxpayer for purposes of Section 1031. Note that the exchange agreement may also be executed by both the taxpayer and the disregarded entity, rather than having the disregarded entity assign its rights in the exchange agreement to the taxpayer after the sale of the relinquished property.

The Service has also ruled that a limited liability company with two members will be considered a single member limited liability company if the sole role of one of the members is to prevent the other member from placing the limited liability company into bankruptcy. The limited role member had no interest in the LLC's profits or losses nor any management rights other than the limited right regarding bankruptcy. Therefore, the Service ruled that the LLC would not be treated as a partnership for federal tax purposes.<sup>5</sup>

The Service issued a revenue ruling holding that a partnership will be considered a disregarded entity when the partners consist of partner X and a disregarded entity wholly owned by partner X.<sup>6</sup> For example, a partnership is disregarded for federal tax purposes if its partners are X corporation and Y LLC, whose sole member is X corporation. This was a common structure in Texas for franchise tax reasons.

Relying on this revenue ruling, the IRS also ruled that a taxpayer can acquire 100% of the partnership interests in a limited partnership that owns the replacement property, rather than acquiring direct title to the replacement property itself.<sup>7</sup> Pursuant to Rev. Rul. 99-6, the limited partnership is considered to have terminated under I.R.C. § 708(b)(1)(A) and made a liquidating distribution of its assets to its partners, and the taxpayer is treated as having acquired 100% of such assets from the partners for federal tax purposes, rather than as having acquired partnership interests from the partners. The ruling holds that this transaction is not an exchange of partnership interests in violation of I.R.C. § 1031(a)(2)(D).

Private letter rulings have also been issued treating the purchase of 100% of the membership interests in a single member limited liability company as the purchase of the assets held by the limited liability company.<sup>8</sup> This allows a taxpayer to exchange out of or into the membership interests rather than the assets themselves. This might save transfer taxes, sales taxes, or recording fees in some states. In the private letter ruling, the qualified intermediary (QI) was a single member limited liability company and a disregarded entity for federal tax purposes. The QI acquired the replacement real property from the seller and the taxpayer then acquired 100% of the interests in the QI from the QI's sole member. The ruling treated the acquisition of the sole ownership interest in the QI as the receipt off the real property directly by the taxpayer for I.R.C. § 1031. In another ruling, an exchanging party

<sup>4</sup>Ltr. Rul. 200732012.

<sup>5</sup>Ltr. Rul. 9911033.

<sup>6</sup>Rev. Rul. 2004-77, 2004-31 I.R.B. 119.

<sup>7</sup>Ltr. Rul. 200807005.

<sup>8</sup>Ltr. Rul. 200118023, Ltr. Rul. 201216007.

transferred 100% of the membership interests of a limited liability company, which held title to the relinquished property in the exchange.<sup>9</sup>

In another private letter ruling,<sup>10</sup> the taxpayer acquired the replacement property directly and then contributed it to a single member LLC that was a disregarded entity for federal tax purposes. The ruling stated that contribution did not violate the requirement that the replacement property be held for productive use in a trade or business or for investment.

Rev. Rul. 99-5 provides that if a taxpayer owns 100% of a disregarded LLC and sells a portion of the LLC interests to a buyer, the taxpayer is treated as if it first sold an undivided interest in the assets of the LLC to the buyer, and then the taxpayer and the buyer contributed their assets to a new partnership. Thus, the taxpayer's transfer of less than 100% of the LLC interests should qualify as a disposition of that portion of the underlying assets as relinquished property in an I.R.C. § 1031 exchange. The buyer's deemed acquisition of the undivided interest in the underlying property might qualify as replacement property in an I.R.C. § 1031 exchange, but might fail the "qualified purpose" requirement discussed earlier in this chapter because the buyer is deemed to immediately contribute the undivided interest to the new partnership.

**Spouses.** The IRS, in Rev. Proc. 2002-69, has ruled that a limited liability company owned solely by spouses 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 limited liability company has two members.<sup>11</sup> 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. This ruling also applies to foreign countries or possessions of the United States that have community property laws. The spouse limited liability company can convert to a partnership for federal tax purposes by filing a partnership tax return. The community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. The ruling only applies to limited liability companies owned by the spouses as community property.

Married taxpayers in noncommunity property states cannot take advantage of Rev. Proc. 2002-69. Therefore, except as discussed below, they cannot form one limited liability company for the replacement property when the relinquished property was held in their individual names. Generally, a limited liability company with the spouses as the only members would be considered a partnership for I.R.C. § 1031 purposes, and it would result in a different taxpayer taking title to the replacement property and thus an invalid exchange. For example, the instructions to IRS Form 1065, U.S. Return of Partnership Income, provide that if a married couple jointly own and operate an unincorporated business, they are partners and must file a Form 1065 (unless they are in a community property state and can take advantage of Rev. Proc. 2002-69). This is true even if the spouses file their IRS Form 1040 jointly. Partnership status also cannot be avoided if the spouses hold the membership interests in the LLC in a tenancy-by-the-entirety or as joint tenants. These forms of ownership are not community property. Likewise, married individuals cannot avoid partnership status by placing the LLC interests in a single revocable living trust with the spouses as grantors. A grantor trust is not a separate taxpayer for these purposes and the tax owners of the LLC would be the spouses, individually. Thus, the LLC would still be a partnership for federal tax purposes.

<sup>9</sup>Ltr. Rul. 201216007.

<sup>10</sup>Ltr. Rul. 2001310014, Ltr. Rul. 200521002.

<sup>11</sup>Rev. Proc. 2002-69, 2002-45 I.R.B. 831.



As a limited exception, I.R.C. 761(f) provides that a married couple in a "qualified joint venture" (QJV) will not have to file as a partnership. This provision would allow the spouses to form a limited liability company and still report the activity on their Form 1040 rather than a Form 1065, and thus the QJV would be the same taxpayer as the spouses. For a QJV, the spouses must file a joint return for the taxable year, elect to have I.R.C. § 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.<sup>12</sup> "Material participation" is defined under passive activity rules as being involved in the operation of the activity on a regular, continuous, and substantial basis.<sup>13</sup> The regulations to the passive loss rules in I.R.C. § 469 provide several alternative tests for "material participation" that could apply to rental real estate owners or other property owners doing an exchange under Section 1031.<sup>14</sup> However, these tests require substantial activities that may be difficult for many taxpayers to meet with rental real estate. For examples, these tests include the spouses each participating more than 500 hours in the activity for the taxable year.

The instructions to 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 I.R.C. § 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]."<sup>15</sup>

If the spouses in a non-community property state cannot meet the tests for a QJV, including the "material participation" test, as an alternative, each spouse can form his or her own single member limited liability company and own the replacement property as 50/50 co-owners. A tenancy by the entirety is generally a tenancy in common between spouses with right of survivorship. It is not the same as community property, in which the spouses are presumed to each own one-half of the whole asset. The spouses can then continue to report ownership of the replacement property on their joint 1040 tax return.<sup>16</sup>

#### § 2:48 Same taxpayer requirement—Corporations

If a corporation owns the relinquished property at the time of the exchange, the corporation, and not its shareholders, must acquire the replacement property.<sup>1</sup> Similarly, if the shareholders own the relinquished property at the time of the exchange, the corporation cannot acquire the replacement property because it is a

<sup>12</sup>I.R.C. § 761(f)(2)(B).

<sup>13</sup>I.R.C. § 469(h).

<sup>14</sup>Temp. Reg. § 1.469-5T.

<sup>15</sup>CCA 200816030.

<sup>16</sup>Ltr. Rul. 9807013.

#### [Section 2:48]

<sup>1</sup>Rev. Rul. 73-72, 1973-1 C.B. 368; *W & B Liquidating Corp. v. Commissioner of Internal Revenue*, 71 T.C. 493, 1979 WL 3858 (1979), regarding I.R.C. § 1033.

different taxpayer.<sup>2</sup> Likewise, the same corporation must acquire the replacement property even if it is part of a consolidated return with other corporations.<sup>3</sup>

The IRS has issued several rulings regarding various types of nontaxable corporate reorganizations that fall under I.R.C. § 381(a), holding that if the predecessor corporation transfers relinquished property in a deferred exchange under I.R.C. § 1031(a)(3), the successor corporation may acquire the replacement property to complete the exchange. The successor corporation "steps in the shoes" of the transferor corporation with respect to the exchange in these reorganizations. These rulings first note that I.R.C. § 381(a) specifically provides for the carryover of certain tax attributes in certain types of reorganizations. However, I.R.C. § 381(a) does not apply to exchanges because I.R.C. § 1031 is not listed in I.R.C. § 381(c). According to its legislative history, however, I.R.C. § 381 is not intended to affect the carryover treatment of an item or tax attribute not specified in I.R.C. § 381 or the carryover treatment of items or tax attributes in corporate transactions not described in I.R.C. § 381(a). Congress did not intend I.R.C. § 381(c) to be the exclusive list of attributes that should be carried over after a reorganization. Thus, no inference should be drawn from I.R.C. § 381 about the utilization, under existing tax law, of any item or tax attribute by a successor or predecessor corporation.<sup>4</sup> The rulings find that the policy concerns that gave rise to I.R.C. § 1031, the lack of cashing out of the investment and the administrative convenience, apply equally to the particular nontaxable reorganization in the ruling.<sup>5</sup> The rulings then hold that tax attributes carry over under I.R.C. § 1031(a)(3) in the specific type of corporate reorganization discussed in the ruling and that the successor or surviving corporation may receive like-kind property in exchange for property transferred by a predecessor corporation.

In one ruling, a subsidiary corporation disposed of the relinquished property. It was then liquidated into its parent under I.R.C. § 332. The parent also merged with another corporation in a reorganization under I.R.C. § 368(a)(1). The parent was treated as the transferor of the relinquished property and was therefore allowed to acquire the replacement property during the exchange period in the exchange.<sup>6</sup> The IRS has also approved an exchange with a merger combined with a "spin off" during the exchange period. The taxpayer's subsidiary disposed of the relinquished property and then merged with another subsidiary under I.R.C. § 368(a)(1)(A). The stock of the successor corporation was then distributed to the shareholders of the taxpayer in a spin off in a reorganization under I.R.C. § 368(a)(1)(D) that met the requirements of I.R.C. § 355. The successor corporation was allowed to acquire the replacement property and was treated as the transferor in the exchange.<sup>7</sup> The IRS has further ruled that two subsidiary corporations within the same controlled group may merge during the exchange period and the surviving corporation may acquire the replacement property for the merged corporation's exchange.<sup>8</sup> Likewise, the IRS has ruled that a corporation may be acquired by a publicly traded REIT during the exchange period in a reorganization under I.R.C. § 368(a)(1)(C) and the REIT will be

<sup>2</sup>Hill v. Commissioner of Internal Revenue, 66 T.C. 701, 1976 WL 3621 (1976), regarding I.R.C. § 1033.

<sup>3</sup>Vim Securities Corporation v. Commissioner of Internal Revenue, 130 F.2d 106, 42-2 U.S. Tax Cas. (CCH) P 9602, 29 A.F.T.R. (P-H) P 1059 (C.C.A. 2d Cir. 1942); Feinberg v. C.I.R., 377 F.2d 21, 67-1 U.S. Tax Cas. (CCH) P 9413, 19 A.F.T.R.2d 1366 (8th Cir. 1967), regarding I.R.C. § 1033.

<sup>4</sup>H.R. Rep. No. 1337, 83rd Cong., 2d Sess. A135 (1954); Reg. § 1.381(a)-1(b)(3)(i).

<sup>5</sup>See, e.g., Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 98th Cong., 2d Sess. 244-45 (1984); Starker v. U.S., 602 F.2d 1341, 1352, 79-2 U.S. Tax Cas. (CCH) P 9541, 44 A.F.T.R.2d 79-5525 (9th Cir. 1979).

<sup>6</sup>Ltr. Rul. 9751012.

<sup>7</sup>TAM 9252001.

<sup>8</sup>Ltr. Rul. 200151017.

treated as the transferor of the relinquished property and thus may acquire the replacement property.<sup>9</sup>

All of the above rulings were corporate reorganizations covered by I.R.C. § 381(a) and the carryover of tax attributes. There are no rulings on reorganizations not covered by I.R.C. § 381, such as a "split up" or "split off" between shareholders during the exchange period. However, the IRS has ruled that if a dividing partnership in a partnership division under I.R.C. § 708 disposes of property in an I.R.C. § 1033 transaction and makes an election to replace the property, the continuing partnerships may acquire the replacement property.<sup>10</sup>

Changes in the ownership of the stock of a corporation during the exchange period should not affect the exchange because the corporation remains a separate entity for tax purposes.<sup>11</sup>

A qualified subchapter S subsidiary (Qsub) is not treated as a separate corporation for tax purposes and the receipt of replacement property by the Qsub should be treated as receipt by the parent S corporation.<sup>12</sup>

See Chapter 9 for a discussion of changes in ownership prior to or after an exchange.

### § 2:49 Exchange requirement

An exchange requires a reciprocal transfer of property for property. A sale of property followed by the purchase of qualifying replacement property does not qualify for non-recognition of gain under I.R.C. § 1031, if even the properties are otherwise like-kind and the identification and receipt requirements are otherwise met.<sup>1</sup> The intent to exchange is not dispositive on the question of whether an exchange occurred.<sup>2</sup> The exchange must also be structured correctly. The courts, however, will look to the taxpayer's intent if the activities of the parties do not compel the conclusion that a sale occurred.<sup>3</sup> While there is no practical difference between the substance of a sale and a reinvestment and the substance of an exchange of properties, there is a difference in the tax treatment.

Under the Regulations to I.R.C. § 1031, a sale of relinquished property and the acquisition of replacement property can easily be converted into an exchange through an intermediary acting under the terms of an exchange agreement and within the provisions of Safe Harbor No. 3. An intermediary acts within the provisions of Safe Harbor No. 3 when the intermediary acquires the relinquished property from the taxpayer, transfers the relinquished property to the taxpayer. The intermediary, or a qualified trust, or a qualified escrow account must hold the replacement property and transfers the replacement property to the taxpayer. The exchange proceeds following the transfer of the relinquished property and before the acquisition of the replacement property under the substantial limitations and restrictions imposed by Reg. § 1.1031(k)-1(g)(6). In addition, a taxpayer's access to

<sup>9</sup>Ltr. Rul. 9152010.

<sup>10</sup>Ltr. Rul. 200921009.

<sup>11</sup>Ltr. Rul. 8248050.

<sup>12</sup>Ltr. Rul. 9909054.

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<sup>1</sup>Reg. § 1.1031(k)-1(a).

<sup>2</sup>Bezdjian v. C.I.R., T.C. Memo. 1987-140, T.C.M. (P-H) P 87140, 53 T.C.M. (CCH) 368, 1987 WL 40232 (1987), judgment aff'd, 845 F.2d 217, 88-1 U.S. Tax Cas. (CCH) P 9306, 61 A.F.T.R.2d 88-1105 (9th Cir. 1988).

<sup>3</sup>Biggs v. C. I. R., 632 F.2d 1171, 81-1 U.S. Tax Cas. (CCH) P 9114, 47 A.F.T.R.2d 81-484 (5th Cir. 1980); Alderson v. C.I.R., 317 F.2d 790, 63-2 U.S. Tax Cas. (CCH) P 9499, 11 A.F.T.R.2d 1529 (9th Cir. 1963); Barker v. Commissioner of Internal Revenue, 74 T.C. 555, 1980 WL 4456 (1980).