

1031 Exchange: Same Taxpayer Rule

What is the Same Taxpayer Rule in a 1031 Like-Kind Exchange?

In a 1031 exchange, the taxpayer who owns the relinquished property must be the same taxpayer who takes ownership of the replacement property.

Keep in mind that one of the justifications for tax deferral is that a taxpayer has reported all the incidences of ownership and that the taxpayer's basis will carry over into the new replacement property. The taxpayer is only getting deferral, not permanent tax avoidance, and the sheltered gain will be due ultimately upon a future sale of the property without an exchange. If the taxpayer were to change tax identities within an exchange, there would be no continuity of tax ownership and no reason to allow deferral.

In addition, the exchange regulations provide that the same taxpayer must transfer the relinquished property, as well as receive the transfer of the replacement property. If, for tax purposes, the taxpayer changes its tax identity between the sale and the purchase, then the same taxpayer will not have disposed of and received property. So, while the same taxpayer requirement will not be found by those words in the regulations, it is very clearly implicit.

Can a Taxpayer Change the Ownership, but Maintain the Tax Identity?

Remember that we are talking about the tax identity, not necessarily the specific name of the title of the property. So let's look at some various ways in which a taxpayer can hold title that would preserve the tax identity:

- Hold title in taxpayer's own name
- Hold title under a single member limited liability company (LLC)
- Hold title as the trustee of a Revocable Living Trust
- Hold title as beneficiary of an Illinois type land trust
- Hold title as a Tenant in Common (TIC)
- Hold title under a A Delaware Statutory Trust (DST)

Below we will explain each scenario mentioned above.

Holding Title in the Taxpayer's Own Name

Using the taxpayer's own name is the most common form of ownership. This ownership can be as an individual, LLC, partnership, etc. There is always a tax identification number associated with this ownership.

Holding Title as a Single Member LLC, Trustee of a Revocable Living Trust, or TIC

Single member LLCs and Self Declarations of Trust (Living Trust) are known as "tax disregarded entities." These entities are taxed to the party that is the sole member of the LLC or the grantor/beneficiary of the trust. A TIC is also deemed to be owned by the owner of that Tenant in Common share. The fact that

there are other co-owners of the property has no adverse consequences to the taxpayer being the same taxpayer who sold the property individually.

Holding Title under a Delaware Statutory Trust

DSTs themselves are regarded as a trust, however the owner of a DST share is regarded as owning a beneficial interest in the trust. As such, a person selling as an individual but buying through a DST interest is still treated as the same taxpayer assuming the beneficial interest is held in the same individual taxpayer's name. In 2004, the IRS issued a ruling confirming that the use of a DST for the purchase of replacement property was permissible with certain restrictions.

Holding Title as Beneficiary of an Illinois Type Land Trust

The Illinois Land Trust is similar to the DST in that the owner of the trust interest is considered to be holding the beneficial interest in the trust that holds title to the property. Since an exchange of a "beneficial interest" was not allowed under Section 1031 in the past, many sellers of property within a land trust faced a lot of uncertainty as to how to proceed. Eventually the IRS issued Private Letter Ruling 92-105 confirming that due to the unique nature of an Illinois Land Trust, the beneficiary causing sale of land trust property would qualify for a real estate exchange and was not subject to the beneficial interest prohibition.

The Same Taxpayer Rule and Spouses

There are times when only one spouse is on title to the relinquished property and the taxpayer would like to add the spouse to the title to the replacement property. This is not encouraged since the other spouse was not the same taxpayer who sold the relinquished property. When a taxpayer does want to bring the spouse on title, advisors usually suggest waiting until the "exchange is old and cold" - waiting several years should be sufficient.

Other times, only one spouse will be on title to property but the lender in connection with the replacement property financing will require the additional spouse to go on title as a condition of the loan. If this is a written request from the lender, rather than the taxpayer's election, it is unlikely that the IRS would find it objectionable. Should someone wish to use an abundance of caution, a document could be drawn up confirming that the additional spouse is holding the interest "in trust" on behalf of the original spouse.

Death of a Taxpayer during a 1031 Exchange

There are instances in which a taxpayer passes away at a point in time after the sale of the relinquished property and before the purchase of replacement property. If the exchange is not continued, the estate would be taxed on the gain from the sale. However, in spite of the fact that a deceased individual and his estate are not the same taxpayer, the regulations do allow the estate to continue the exchange transaction and receive deferral.

Summary

The theory behind like-kind exchange tax deferral is based upon continuity of a taxpayer's investment. Implicit with this is that if the taxpayer changes between the disposition of an asset and the acquisition, there cannot be continuation of the taxpayer's investment. However, there are various types of property-holding arrangements, many of which are disregarded for tax purposes, that allow for a taxpayer to hold relinquished property in a different name while meeting the same taxpayer requirement.