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What's in a Name?

The Same Taxpayer Requirement of Section 1031

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Many taxpayers are not aware that one of the essential elements for a valid Section 1031 like-kind exchange is that title to the replacement property be held the same way as title to the relinquished property was held. The language of Section 1031 does not explicitly require this, but the requirement in Section 1031(a)(3) that replacement property must be received by the "taxpayer" within 180 days of the date that the "taxpayer" sold the relinquished property has been interpreted to mean such. This requirement has implications for relinquished property held by any of the following: spouses, trusts, partnerships, limited liability companies, corporations, land trusts, and Delaware statutory trusts. Each of these ownership types, and the implications of ownership by "disregarded entities," will be discussed below.

Spouses

If relinquished property is held in the name of only one spouse, then the replacement property should be held only in that spouse's name. That spouse might be able to make a tax-free gift of the replacement property to the other spouse at a later date. In order to avoid a step-transaction challenge, or suspicion that the transfer is a pre-arranged gift, the title-holding spouse should hold the replacement property in his name for a considerable period prior to transferring an interest to his spouse. *Click v. Commissioner of Internal Revenue*, 78 T.C. 225 (1982).

If relinquished property is held in both spouses' names, then the replacement property should also be held in both their names. In Technical Advice Memorandum 8429004, based on a North Carolina transaction, the replacement property was acquired only in the husband's name, and the IRS ruled that the wife gifted her share of the proceeds to her husband and must therefore report 50% of the gain on the sale of the property.

Revocable Living Trusts

A revocable living trust, or grantor trust, is considered a disregarded entity for federal tax purposes. The taxpayer usually uses his own tax identification number and does not file a separate tax return for the trust. The individual, not the trust, is the taxpayer for purposes of Section 1031. A taxpayer who holds relinquished property in his name may purchase replacement property in the name of a revocable living trust. This is a popular estate planning tool. A taxpayer who owns relinquished property in a revocable living trust may purchase replacement property in his individual name outside of the trust. A taxpayer may also transfer the relinquished property into a revocable living trust just prior to the exchange, or transfer the replacement property into a revocable living trust just after the exchange has ended without violating the holding period requirements of Section 1031. Ltr. Rul. 91106006; Rev. Rul. 2004-86.

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Land Trusts

In Revenue Ruling 92-105, the IRS ruled that for 1031 exchange purposes, an interest in a land trust created under Illinois state law is considered to be an interest in the real property owned by the land trust, and not an interest in personal property or a beneficial interest in the trust. This ruling also applies to land trusts created under the laws of other states provided that the trustee has title to real property; the beneficiary has the exclusive right to direct the trustee regarding the title to the real property; and the beneficiary has the exclusive control of the management of the property, the exclusive right to earnings from the property, and is obligated to pay taxes and liabilities on the property. Where the trustee's only responsibility is to hold and transfer property at the direction of the beneficiary, a trust will not be established for federal tax purposes. Please note that this ruling does not apply to Real Estate Investment Trusts (REITs) – an interest in a REIT does not qualify for Section 1031 treatment, because that interest is a securities interest which is excluded pursuant to §1031(a)(2)(C).

The taxpayer should be careful to make sure that his land trust cannot be classified as a partnership for tax purposes, since partnership interests cannot be exchanged under Section 1031. Private Letter Rulings 8113078 and 8346089 dealt with a land trust with multiple beneficiaries who had an agreement between them that was similar to a partnership agreement.

Delaware Statutory Trusts

In Revenue Ruling 2004-86, the IRS ruled that a beneficial interest in a Delaware Statutory Trust will be considered an interest in real property held by the trust for Section 1031 purposes. In this revenue ruling, the trustee's actions were limited to collecting and distributing income to the beneficiaries; therefore, the DST was classified as a trust for federal income tax purposes. Each beneficial interest in the DST represented an interest in a grantor trust and each individual owner was considered to own an undivided interest in the real property.

The Service did state, however, that if the trustee had one or more of the following powers, the DST would have been classified as a partnership or corporation for federal tax purposes, which would have prohibited the exchange of the beneficial interests in the DST: (i) dispose of the real property and acquire new property; (ii) renegotiate or enter into a lease for the property; (iii) renegotiate or refinance the loan on the property; (iv) invest cash received; or (v) make more than minor non-structural modifications to the real property not required by law.

Partnerships and Limited Liability Companies

Pursuant to Technical Advice Memorandum 9227002, if the relinquished property is held in the name of a partnership or LLC, then the replacement property must be purchased in the name of the partnership or LLC. Technical Advice Memorandum 9818003 states that the individuals may not liquidate the partnership or LLC and purchase replacement property in their own names. In Private Letter Ruling 99935065, the IRS allowed an LLC to convert to a limited partnership during the exchange. A general partnership may convert to a limited partnership and a partnership may convert to an LLC or vice versa.

The ownership of the partnership or LLC may change during the exchange period. If 50% or more of the interests in the partnership is sold within a 12-month period, the partnership needs to make sure that said change does not result in a termination of the partnership under Section 708(b)(1)(B).

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NC Fun Facts

With its white sandy bottom and lack of currents, tides, or swimming hazards, White Lake, NC has been labeled the "Nation's Safest Beach." Located near Elizabethtown in southeastern NC, White Lake is a favorite vacation spot for families.

What's in a Name? (cont. from page 2):

Private Letter Ruling 200807005 reiterates prior rulings by stating that acquisition of all of the partnership interests by the taxpayer in a disregarded entity, rather than taking title to the property, is allowed. In this case, rather than taking title in an LLC, the taxpayer formed a single-member LLC to be one of the partners, with the taxpayer as the other partner. For federal tax purposes, since the LLC partner was disregarded as a separate entity from the taxpayer partner, the partnership was wholly-owned by the taxpayer, and is a disregarded entity for federal tax purposes, even though it is considered a partnership under state law.

Single-Member Limited Liability Companies

A single-member LLC is a disregarded entity for federal tax purposes. The LLC usually uses the tax identification number of the sole member and the no separate tax return is filed for the LLC. An individual may sell relinquished property titled in his name and purchase replacement property in the name of his single-member LLC, giving the taxpayer the protection of a limited liability company. Conversely, a taxpayer may sell relinquished property titled in his single-member LLC and purchase replacement property in his individual name.

Private Letter Ruling 2001118023 states that the purchase of 100% of the membership interests in an LLC is the purchase of the assets of the LLC. This is a popular method of transfer in a reverse 1031 exchange, as it allows the taxpayer to save on transfer taxes and recording fees in some states, since there is no deed involved in the transfer, only an assignment of the membership interests in the LLC. In Private Letter Ruling 2001310014 and Private Letter Ruling 200521002, the IRS allowed the taxpayer to purchase replacement property in his individual name and then immediately contribute it to a single-member LLC without violating the holding period requirement of Section 1031.

In the community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin), an LLC owned solely by a husband and wife as community property can be considered a disregarded entity for federal tax purposes even though the LLC has two members, pursuant to Revenue Procedure 2002-69. In a non-community property state, if the husband and wife own relinquished property in both of their names and want to purchase replacement property in an LLC, some authorities have suggested that each of them can form their own single-member LLC, with the LLCs holding the replacement property as co-tenants (Jeremiah M. Long & Mary B. Foster, Tax-Free Exch Under § 1031 § 2:44 (2009)).

Corporations

If relinquished property is held in the name of a corporation, then the replacement property must also be purchased in the corporate name, not in the name of the shareholders. Conversely, if the shareholders own the relinquished property, then the shareholders, and not the corporation, must purchase the replacement property.

In a corporate reorganization, the IRS has allowed a predecessor corporation to sell relinquished property and the successor corporation to purchase the replacement property in an exchange. In Private Letter Ruling 9909054, the IRS ruled that a qualified subchapter S subsidiary is not considered to be a separate corporation from its parent corporation; therefore, a qualified subchapter S subsidiary may sell relinquished property and the parent corporation may purchase the replacement property, and vice versa.

It is essential that the same taxpayer requirement be complied with for a 1031 exchange to be successful. A taxpayer who wants to take title to replacement property in a different name than how he held title should consult with his tax advisor to make sure that he meets the same taxpayer requirement. As always, we at Investors Title are available to discuss this issue with either the taxpayer or his tax advisor, and direct you to any authority on point.

RESPA ROUNDUP

Click here to view the RESPA ROUNDUP.

The Office of RESPA and ILS will periodically issue the RESPA Roundup to enhance communications with consumers and industry stakeholders by providing information on RESPA topics chosen specifically to address the most pressing issues. Click the link above or visit www.hud.gov/respa to access the first issue.

Improper Summary Judgment

The North Carolina Court has ruled that summary judgment is not proper when there are genuine issues of material facts in litigation to partition real estate owned as tenants by the entirety. The case developed after Judy and Clarence Dillingham were divorced in July 2005. Two years later—in October 2007—Judy filed a Petition for Partition of Real Estate, claiming that she was entitled to a portion of several pieces of real property that the couple had acquired during their marriage as tenants by the entirety. The trial court granted her Motion for Summary Judgment in November 2008, and her husband appealed. On appeal, Clarence argued that it was their intention to buy the properties with the ultimate goal of distributing them to their son, Drew, and that Judy therefore held the property in a resulting trust. The Appeals Court examined a number of issues on appeal, but on the subject of partition, the Court reversed. In reaching that outcome, the Court said that it was not required to decide the merits of each argument, only that there were genuine issues that should be heard. On that issue, the Court concluded, "a genuine issue of fact exists as to whether petitioner holds [the] properties in a resulting trust for respondent." Accordingly, the case was remanded for additional proceedings.

--*Dillingham v. Dillingham,* No. COA09 507, N.C. Ct. App. 2/2/10

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Please join us for 6 hours of North Carolina CLE (including 2 Ethics hours)

Friday:

- Registration & Lunch 11:30 am – 12:30 pm
- Opening Remarks 12:30 – 1:00 pm
- 4 (1 hour) Courses 1:00 – 5:30 pm
- Cocktail Reception 5:30 – 8:30 pm

Saturday:

- Registration and Breakfast 7:30 – 7:45 am
- 2 (1 hour) Courses 7:45 – 10:00 am
- Pre–Game Tailgate Party at the Investors Title Corporate Office (time TBD)
- UNC vs. Clemson Football Game (time TBD)
  Ticket availability is limited to 2 per seminar attendee. Reserve tickets early.

Visit *nc.invtitle.com* and click on Resource Center/ Seminars/Registration to register and reserve your hotel room. At the registration site you'll find the complete brochure and course descriptions.

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Cut the Cards

Part II

Increasingly, lenders seeking to enforce their mortgages, or purchasers of property, find themselves victims of claims of fraud or forgery when a party with an interest in the property denies having executed the documents of title or having authorized the transaction. The first line of defense for such claims is the notarized signature on the documents. That line of defense quickly unravels when it is learned that the alleged execution of the documents was not done in the presence of the notary who notarized the documents. Instead, the "false notarization" lends the claim of fraud or forgery authenticity, regardless of the actual facts surrounding the transaction.

Similar problems arise when documents are executed and notarized in the presence of the attorney or staff without requiring picture identification from parties not known to the person witnessing the execution. Later, a necessary party to the transaction may claim that they were not in fact present, and, even worse, they may be able to prove it. The alleged husband or wife of the client, whom the attorney or his staff may not have met, may actually be the boyfriend or girlfriend of the client. Pre-closing instructions to real estate clients should include a statement that a valid picture identification will be required at closing from **all** parties who will be executing documents.

The prudent attorney may trust his or her clients, but must ensure that all attorneys and paralegals in the office have the discipline to "cut the cards" by always following established procedures which are adopted to eliminate the possibility of fraud.

ALTA 5-06 Endorsement

The ALTA 5-06 endorsement provides coverage for planned unit developments in a manner similar to that provided for condominiums by an ALTA Form 4-06. The ALTA form 5-06 insures against loss or damage due to violations of restrictive covenants, forfeiture or reversion provisions of restrictive covenants, assessments gaining priority over an insured mortgage, compelled removal of improvements due to encroachment, and failure of title by reason of a right of first refusal. The endorsements reads as follows:

The Company insures against loss or damage sustained by the Insured by reason of:

1. Present violations of any restrictive covenants referred to in Schedule B that restrict the use of the Land. The restrictive covenants do not contain any provisions that will cause a forfeiture or reversion of the Title. As used in this paragraph 1, the words "restrictive covenants" do not refer to or include any covenant, condition or restriction (a) relating to obligations of any type to perform maintenance, repair or remediation on the Land, or (b) pertaining to environmental protection of any kind or nature, including hazardous or toxic matters, conditions, or substances, except to the extent that a notice of a violation or alleged violation affecting the Land has been recorded in the Public Records at Date of Policy and is not excepted in Schedule B.
2. The priority of any lien for charges and assessments at Date of Policy in favor of any association of homeowners that are provided for in any document referred to in Schedule B over the lien of any Insured Mortgage identified in Schedule A.
3. The enforced removal of any existing structure on the Land (other than a boundary wall or fence) because it encroaches onto adjoining land or onto any easements.
4. The failure of the Title by reason of a right of first refusal to purchase the Land that was exercised or could have been exercised at Date of Policy.