Like-Kind Exchange Corner

Some Additional Thoughts on the Same Taxpayer Requirement of Code Secs. 1031 and 1033: Spouses and Trusts

By Mary B. Foster

Introduction

The same taxpayer requirement under Code Secs. 1031 and 1033 was discussed in a series of four columns in the 2009–2010 editions of the *Journal of Passthrough Entities*.[1] Under this requirement, the same taxpayer that disposes of the relinquished property in an exchange or involuntary conversion must also acquire the replacement property to qualify for the gain deferral. If another taxpayer acquires the replacement property, then the exchange or involuntary conversion will not be eligible for non-recognition of gain treatment under these Code provisions. A few limited exceptions do exist, as discussed in those columns. In this column, I discuss some additional ideas on the same taxpayer requirement for spouses and trusts.

Spouses

If the same taxpayer is strictly applied to spouses, then a spouse that holds the relinquished property as his or her separate property must acquire the replacement property as separate property, even if the spouses prefer to acquire the replacement property together. Once the replacement property is acquired as the spouse's separate property, many tax professionals recommend that the couple should wait a period of one or two years before converting it to a joint ownership. This is because Code Secs. 1031 and 1033(g) also require that the replacement property be held by the taxpayer for a qualified use, and a planned gift of the replacement property shortly after acquisition by the taxpayer violates this qualified use requirement.[2]

In the real world, the same taxpayer rule can be cumbersome to apply to spouses. The relinquished property often was acquired by one spouse prior to marriage or through inheritance. At the time of the exchange, the couple has been married many years and filing income tax returns jointly. They consider the relinquished property a marital asset, even though legal title was never changed from one spouse's separate property.[3] They do not understand why they cannot acquire the replacement property jointly. The spouse who is not in title may be particularly upset by this. While the amount of gain deferred may be substantial for the couple given their net worth, it is does not warrant spending a significant amount on legal fees. It seems unfair that they must retain separate property status for a

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period of time, and then later remember to hire a lawyer to prepare a deed to retitle the property, to update the title policy, pay recording fees, *etc*. Furthermore, if the couple is obtaining financing for the replacement property, the lender may require joint ownership. This might make it impossible to take legal title to the replacement property in only one spouse's name. Perhaps Code Sec. 1041 offers a solution to these problems.

Code Sec. 1041 provides that no gain or loss is recognized on transfers of property between spouses or incident to a divorce. Any transfer is treated as a gift between the spouses, even if the transfer is otherwise a sale between the spouses. This rule applies regardless of whether the property transferred is separately owned by the transferor spouse.[4] For basis purposes, the transferee spouse takes a carryover tax basis in the property, regardless of whether the adjusted basis of the transferred property is less than, equal to, or greater than its fair market value at the time of transfer.[5]

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Code Sec. 1041 was enacted in 1984, shortly after the issuance of a technical advice memorandum involving the same taxpayer requirement for spouses under Code Sec. 1033.[6] The couple in the TAM held the converted property as tenants in the entirety, but the replacement property was acquired solely in the husband's name. The IRS ruled that because the wife's name was not on the deed to the replacement property, she gifted her portion of the proceeds to her husband. Under pre-Code Sec. 1041 law, she had to report 50% of the gain on the conversion of the converted property.

The holding in this TAM would also apply to a Code Sec. 1031 exchange done under pre-Code Sec. 1041 law. Thus, if a husband and wife disposed of the relinquished property and the husband acquired the replacement property in his name only, the wife's half of the exchange would be taxable. Under the same reasoning, if a husband owned the relinquished property as his separate property, but acquired the replacement property in the exchange as marital or community property with his wife, then only the husband's half of the replacement property would qualify as replacement property in his exchange. The husband would likely be trading down in value and his exchange would be taxable. This is a harsh result for couples trying to simplify their marital holdings.

Does Code Sec. 1041 modify this result? It does not specifically state that spouses are the same taxpayer for the purposes of Code Sec. 1031 or 1033, nor does it specifically override the same taxpayer requirement. Further, there are also no rulings on the issue, other than the pre-Code Sec. 1041 TAM discussed above. Compare this to the rulings under the corporate reorganization area in which the successor corporation is considered the same taxpayer under Code Sec. 1031 as the predecessor corporation, if there is a carryover of tax attributes under Code Sec. 381(a).[7] It can be argued that Code Sec. 1041 basically provides for a carryover of tax attributes for transfers between spouses and a similar reasoning should apply.

A few years after I wrote the 2010 column on this issue, I participated in a discussion of the holding of the TAM with the attorneys at the IRS National Office. They considered their position on the issue by examining the legislative history of Code Sec. 1041. Under prior law, some transfers between spouses were taxable. Congress believed this was inappropriate because the Internal Revenue Code treats spouses as a single economic unit. Code Sec. 1041 thus was enacted to avoid traps for the unwary, as, for example, where the spouses viewed property acquired during marriage (even though held in one spouse's name) as jointly owned. Code Sec. 1041 was also meant to "make the tax laws as unintrusive as possible with respect to relations between spouses."[8] The attorneys at the IRS National Office concluded that, given the clear intent of the legislative history of Code Sec. 1041, they would not want to take up the matter of the same taxpayer requirement for spouses. This discussion, while clearly not authority, may give comfort to those who believe the TAM is incorrect under current law and want to title the replacement property in accordance with the spouses' wishes.

Other Solutions. There can be other methods of addressing the same taxpayer requirement for spouses. For example, if the spouses want to keep the ownership of the replacement property consistent with the separate ownership of the relinquished property, they can add the other spouse to legal title for any trade up in value and equity on the replacement property.

Example. Spouse A disposed of the relinquished property valued at $750,000 and the replacement property will cost $1,000,000. The replacement property can be acquired by the spouses as tenants in common, with a 75% interest acquired by spouse A as replacement property and a 25% interest acquired by spouse B as a new purchase.

Divorcing Spouses

In some exchanges, the spouses may be separated and in the middle of dividing up their assets. Even though they dispose of the relinquished property as marital property, they can acquire replacement property as their separate property. Each spouse uses one-half of the exchange proceeds to that satisfy his or her exchange requirement by acquiring the replacement property in his or her name as separate, non-marital property.

The spouses may dispose of the relinquished property as marital property, but then enter into a property settlement during the exchange period, with one spouse being awarded the rights under the exchange agreement to acquire replacement property. If that spouse acquires the replacement property as separate, non-marital property, as discussed above, it seems likely that Code Sec. 1041 should override the old TAM to make the exchange nontaxable. But, of course, there are no specific rulings to rely on in this situation.

Spousal LLCs

Many spouses who owned the relinquished property as marital or community property in their individual names want to acquire the replacement property in a limited liability company ("LLC") to add a layer of liability protection. In some cases, the lender on the replacement property may require that an LLC take title. The couple, who file jointly, believe that they can form one LLC that will qualify as a disregarded entity ("DRE") and therefore as the same taxpayers as the couple individually. This is true if the LLC interests are community property. Rev. Proc. 2002-69 provides that a spousal LLC can be a DRE but it only applies to LLCs owned by the spouses as community property.[9]

If the spouses in a non-community property state own the relinquished property individually, they cannot simply take title to the replacement property in one LLC with the spouses as the only members. The LLC would be considered a tax partnership and, therefore, a different taxpayer than the individuals who disposed of the relinquished property.[10] This invalidates the non-recognition of gain under Code Sec. 1031 or 1033.

The solution to the problem is to utilize a separate DRE for each spouse in a non-community property state. However, it is difficult to explain to the couple why they must incur the costs of forming two LLCs instead of one. I often hear that tax advisors in some non-community property states are treating spousal LLCs as DREs despite the clear guidance to the contrary. Perhaps there is not much downside in taking this position when gain deferral under Code Sec. 1031 or 1033 is not at stake, but it is risky otherwise.

The "qualified joint venture" provisions of Code Sec. 761(f) do not help spouses in non-community property states with this issue, as these provisions do not apply to LLCs.[11]

IDGTs

The March–April 2010 column discussed the same taxpayer requirement for estates and trusts.[12] It did not contain a discussion of "intentionally defective grantor trusts," or IDGTs. An 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 complete 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.[13] Therefore, the grantor of an IDGT remains responsible for the income tax of the trust. IDGTs will often hold title to real property in an exchange. This raises the question of whether the taxpayer in the exchange is the grantor or the trust for the purposes of the same taxpayer requirement.

While there are rulings regarding revocable trusts and Code Sec. 1031, there are no rulings involving IDGTs. There was some worry that a court might view the two types of trusts differently in a Code Sec. 1031 context because a grantor of a revocable trust retains benefits and burdens of the property and is clearly the tax owner, while the grantor of an IDGT has made a completed gift to the property and does not retain the benefits and burdens of ownership. However, Rev. Rul. 2004-86 regarding Delaware Statutory Trusts provides that a grantor's interest in an irrevocable grantor trust is treated as an interest in the trust property for Code Sec. 1031 purposes.[14] Therefore, applying this to an IDGT, the grantor should remain the taxpayer for Code Sec. 1031 purposes as the deemed owner of the IDGT's assets. Thus, the taxpayer can own the relinquished property individually and acquire the replacement property in the IDGT, or *vice versa*.

Conclusion

Married couples frequently struggle with the same taxpayer requirement. If one spouse holds title to relinquished property as his or her separate property, he or she may want to add the other spouse to legal title in recognition of the long marriage. Code Sec. 1041 may offer some relief for this problem, although it is not entirely free from doubt. It is clear, however, that married couples in non-community property states will have to incur the cost of forming a separate DRE for each spouse. There is no relief from that problem. Finally, the grantor of an IDGT is treated as the taxpayer for Code Sec. 1031 purposes.

ENDNOTES

1. Mary B. Foster, *The Same Taxpayer Requirement of Code Secs. 1031 and 1033 (Spouses),* J. Passthrough Entities, Nov.–Dec. 2009, at 27; *The Same Taxpayer Requirement of Code Secs. 1031 and 1033: Part II—Estate and Trusts*, J. Passthrough Entities, Mar.–Apr. 2010, at 25; *The Same Taxpayer Requirement of Code Secs. 1031 and 1033: Part III—Partnerships and LLCs,* J. Passthrough Entities, July–Aug. 2010, at 29; *The Same Taxpayer Requirement of Code Secs. 1031 and 1033: Part IV—Corporations*, J. Passthrough Entities, Nov.–Dec. 2010, at 27.
2. *D.H. Click,* 78 TC 225, Dec. 38,790 (1982).
3. State law may affect marital property status apart from legal title and this might solve the tax issue. For example, in Washington state, separate property can be converted to community property by commingling of income and expenses for the property with community income, and there is no need for a formal conveyance.
4. Reg. §1.1041-1T(a).
5. Reg. §1.1041-1T(d).
6. TAM 8429004 (Mar. 22, 1984).
7. *See* Mary B. Foster, *The Same Taxpayer Requirement of Code Secs. 1031 and 1033: Part IV—Corporations*, J. Passthrough Entities, Nov.–Dec. 2010, at 27.
8. House Report 98-432 (for H.R. 4170), 98th Congress 1st Session.
9. Rev. Proc. 2002-69, IRB 2002-45, 831; Rev. Proc. 2002-2 CB 831.
10. *See* IRS Publication 541.
11. *See* Instructions to IRS Form 8832; IRS Publication 541.
12. *See* Mary B. Foster, *The Same Taxpayer Requirement of Code Secs. 1031 and 1033: Part II—Estate and Trusts*, J. Passthrough Entities, Mar.–Apr. 2010, at 25.
13. *See* Rev. Rul. 85-13, 1985-1 CB 184; LTR 200842007 (June 24, 2008); CCA 201343021 (Oct. 25, 2013); *but see H. Rothstein*, CA-2, 84-1 USTC ¶9505, 735 F2d 704.
14. Rev. Rul. 2004-86, IRB 2004-33, 191; Rev. Rul. 2004-2 CB 191 (July 20, 2004).