nyrej

Who is the “tax owner” and why it matters in a 1031 exchange - by Pamela Michaels

March 05, 2019 - Front Section

In a 1031 tax deferred exchange, the same tax owner that sells the relinquished property should acquire the replacement property. This issue arises frequently in the Northeast as many times the taxpayer does not wish to have the same person or entity on the deed to the replacement property or is not sure who that person or entity should be. The “tax owner” is the person or entity who has the benefits and burdens of ownership. The tax owner is generally the person or entity which files tax returns for the property, maintains bank accounts, executes legal documents, and appears on the deed as the title owner. However, often the person or entity on the deed may not be the actual tax owner but instead may be what is known as a disregarded entity. A disregarded entity is an entity that is disregarded for federal tax purposes. This means that the entity does not file a tax return in its own name. The tax return is filed by the person or tax owner that is regarded for federal tax purposes. The person or entity that is regarded may have elected to create a disregarded entity and take title in the name of the disregarded entity for a variety of reasons. Often that reason is that the person or entity that is the actual tax owner wishes to remain anonymous or to protect an individual or entity for liability concerning the property. Other times creating a disregarded entity to take title to property is purely for efficiency purposes allowing the owner to quickly distinguish between properties when managing multiple assets.

The most common types of disregarded entities are single member limited liability companies (LLCs.) The sole member is generally the tax owner but it could also be a disregarded entity. Thus, one needs to examine ownership of entities until one finds the person or entity that is the tax owner. Once the tax owner is identified, it is critical to take title to replacement property in the name of that same tax owner or another disregarded entity owned by the same tax owner.

Thus, a taxpayer could sell property in the name of disregarded LLC named “Land Barron, LLC” having as its sole member, Larry Landowner. Larry Landowner would not appear on the deed but all tax returns for the property would be filed by Larry Landowner and not by the LLC. Larry Landowner could initiate an exchange in the name of Land Barron, LLC and buy replacement property in the name of Real Estate Magnate, LLC, as long as Real Estate Magnate, LLC is also a disregarded entity with Larry Landowner being its sole member. Generally speaking, to be a disregarded entity, the LLC may only have one member. Exceptions to that rule are community property states where the members are husband and wife or LLCs or partnerships where all members or partners themselves are disregarded and owned by the same tax owner.

Some other exceptions to this rule:

Partnerships and LLC’s: A taxpayer who elects taxation as a sole proprietorship can hold the relinquished property as an individual but acquire the replacement property as a single-member, single-asset LLC. This provides the benefit of liability protection and also can help satisfy the ‘single asset entity’ requirements that many lenders impose on replacement property purchases. The IRS 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 LLC into bankruptcy provided the limited role member has no interest in LLC profits or losses nor any management rights other than the limited right regarding bankruptcy.

Grantor Trusts: A taxpayer who owns property in his or her individual name can acquire a replacement property in a revocable living trust or “grantor” trust for estate planning purposes. The tax owner of such trust is the grantor or the taxpayer.

Death of a Taxpayer: If the taxpayer dies during the exchange, the taxpayer’s estate may complete the exchange.

Business Consideration/Lender Requirements

Sometimes a business consideration, lender requirement or the taxpayer’s liability issues can make it difficult to keep the vesting entity the same throughout a 1031 exchange. For this reason, it is important that a taxpayer review the entire exchange transaction with their legal and/or tax advisors before closing on the sale of the relinquished property. Some problem areas:

If a wife, as the only taxpayer, is relying on the husband’s income to qualify for replacement property financing, the lender may require that the husband appear on the deed. This could have an impact on the wife’s exchange.

Most lenders are wary about lending to trustees. A taxpayer who relinquishes property in a trust but needs to obtain conventional financing for the purchase may have difficulty obtaining a loan because lenders prefer loaning to an individual.

Sometimes a taxpayer may relinquish a property in one entity such as multi-member LLC, corporation or partnership but want to acquire a replacement property in a different entity. This would disqualify the exchange even if the owners of the entity are identical.

Conflicts Between Title, Tax Records and Actions

In some cases, one may find that a person or entity is on the deed and another has been filling tax returns, maintained bank accounts, managed the property, exectued legal documents etc. In such cases, it may be difficult to determine who is the tax owner of the property and in whose name an exchange should be performed and title to replacement property taken. For instance, if two individuals acquired property in their individual names years ago but then formed a partnership which has since filed tax returns for the property and conducted all business with respect to the property. It would thus appear that the partnership is the tax owner of the property and it may be necessary to file a quitclaim or corrective deed to conform title to the facts. Who is the tax owner is a legal determination to be made by an taxpayer's legal and tax advisors especially if documents and actions conflict in this respect. It is essential for this determination to be made prior to initiating a 1031 exchange as identifying the incorrect person or entity in the exchange documents could result in the exchange being disqualified.

Pamela Michaels, Esq., is sr. VP with Asset Preservation, Inc., New York, N.Y.