EXCHANGES INVOLVING TRUSTS

A threshold issue in any exchange is determining the identity of the taxpayer in the exchange. Determining the identity of the taxpayer requires knowing not only how the property is held, but the characterization of an entity for federal income tax purposes. An entity's tax status for federal income tax purposes does not depend on whether the organization is recognized as an entity for state law purposes.1 Federal tax law determines the status of an entity for tax purposes. When a trust holds title to the property involved in an exchange it is important to look at, under and behind the trust to correctly determine the identity of the taxpayer in the exchange.

Trusts That Are Agents

Some arrangements that are called trusts are not trusts at all for federal income tax purposes. Massachusetts and Illinois frequently use “nominee trusts” (also called “realty trusts” or “land trusts”) to hold title to real estate. Nominee trusts help keep the identity of the beneficiaries confidential, achieve some small degree of creditor protection, for estate planning and to facilitate ease of conveyance as compared to other business entities. A typical nominee trust is considered the agent of the beneficiaries.2

To determine whether a realty or nominee trust is an agent, the advisor should first review the trust instrument. The principal question is whether the trustee can act independently or whether the trustee must follow the directions of the beneficiaries. A true trust for federal income tax purposes involves the transfer of property to the trustee obligated to exercise independent responsibility to protect and preserve the trust property for the beneficiaries, who do not share in this responsibility.3 If the beneficiaries, rather than the trustee exercise independent responsibility concerning the management and disposition of the trust’s property, the trust will not be considered a trust for federal income tax purposes.4 In such a situation, the trust is the agent of the beneficiaries.

If a nominee trust has a single beneficiary, that beneficiary will be the taxpayer in the exchange. It is possible that the beneficiary itself may be a “disregarded entity.” A disregarded entity is any entity (which could be a limited liability company or a business trust) that is owned by a single person or entity. A limited liability company owned by a single individual is “disregarded” as a separate entity from the individual owner; therefore, the individual owner will report the income of the LLC on his or her individual income tax return (Form 1040). The individual could elect under the “check-the-box” regulations to have even a single member LLC taxed as a corporation, but this will rarely be the case.

If the nominee trust has multiple beneficiaries, the arrangement could create either a partnership or co-ownership of property, depending on the facts and circumstances. If a partnership does not exist, then the beneficiaries are considered co-owners. Co-owners would generally be considered to be tenants-in-common with respect to the trust property.

Multiple Beneficiaries Constituting a Partnership

If the nominee trust has at least two beneficiaries, it may constitute a partnership for federal income tax purposes.5 A partnership will exist for federal income tax purposes when two or more persons (individuals or other entities) carry on a business activity for a profit.6 It is surprisingly easy for a partnership to exist for federal income tax purposes, because the definition is broader than the
common law definition of a partnership. However, the mere co-ownership of property itself, without more, will not constitute a partnership. For example, two individuals that own a single parcel of real estate that is triple net leased to a single tenant that performs all maintenance and repairs of the property and pays rent will not be considered a partnership. However, if the two owners acquire a hotel, rent rooms, manage, and maintain the property, the level of activity is significantly greater, and this will likely be considered a partnership.

In between these two extremes is a great gray area in which a partnership may exist, depending on all of the facts and circumstances. The essential factors are the parties’ intentions derived from all the facts and circumstances and the degree of passiveness of the investment activity. If a third party property manager is hired to perform these activities, it does not transform the activity from a partnership into co-ownership. Use of a common business name, even the nominee trust’s name, may be considered a fact favoring the existence of a partnership.

To determine whether a partnership exists, the advisor should first determine whether the nominee trust has filed a federal partnership income tax return (Form 1065) for any of the past years. Filing of a partnership is virtually a de facto admission that a partnership exists. If not, a partnership may be deemed to exist if the level of business activity is beyond a purely passive investment.

**Trusts that are Business Entities**

There are certain types of trusts that are not trusts for the purpose of conserving property, but rather constitute a business enterprise. These entities are business trusts, and their tax classification for federal income tax purposes will be that of a partnership or a corporation.

**True Trusts and Grantor Trusts**

A true trust for federal income tax purposes is one where the trustee holds property under an obligation to exercise independent responsibility to protect and preserve the trust property for the beneficiaries, who do not share in that responsibility. If such a trust owns the property relinquished in an exchange, the trust will often be the taxpayer.

Many times, a true trust under the entity classification rules is considered a “grantor trust” for federal income tax purposes. A trust becomes a “grantor trust” if the grantor establishing the trust reserves certain powers over the trust. These powers include: (i) the power to revoke; (ii) the power to control enjoyment of the trust; and (iii) certain retained reversionary interests. If these powers are reserved, then the grantor will be considered as the owner of the trust for federal income tax purposes, and the tax attributes of the trust property will be taxed to the grantor. The best known example of a grantor trust is a revocable living trust established by a grantor during his or her lifetime for estate planning purposes.

In a Revenue Ruling under §1033, the Service held that a taxpayer could acquire the replacement property in a revocable living trust in which the grantor was treated as the owner of the principal of the trust, even though the condemned property was owned by the taxpayer individually. A recent revenue ruling considered the classification of a Delaware statutory trust for federal income tax purposes. In that ruling, the Service discussed the tax treatment of a trust organized to hold title to property intended to be replacement property for various taxpayers’ like-kind exchanges. The trust would own fee title to the property and the beneficiaries would hold interests in the trust. The ruling indicates that if the trust is a grantor trust, the grantor will be treated as the owner of an undivided fractional interest of the trust assets. If there are multiple beneficiaries of such a trust, it would not constitute a partnership for tax purposes if the trust is a “fixed investment trust.” A fixed investment trust is one where the trustee has no power to vary the investment of the beneficiaries. Essentially, the trustee can only hold the property and collect the income, and cannot sell or manage the property.
This ruling’s rationale, while intended to benefit tenant-in-common (TIC) sponsors selling tenant in common interests as replacement property under Rev. Proc. 2002-22, appears to have broader application. It would be a mistake to read this ruling as meaning that all grantor trusts are disregarded as entities separate from their grantors. However, Rev. Rul. 88-103, together with the recent guidance on Delaware Statutory Trusts indicates that when the real estate being exchanged is owned by a typical revocable living trust, the grantor will most likely be considered as the taxpayer, and acquiring either the relinquished or replacement property in a grantor trust should not cause the exchange to fail by reason of a lack of identity of taxpayer.

Consequences of Type of Entity

In a like-kind exchange, there must be an identity of taxpayer in the exchange. An exchange consists of two “legs”: the first is the sale of the relinquished property or “sale” leg of the exchange, and the second is the acquisition of the replacement property or “purchase” leg of the exchange. When a taxpayer does a LKE, the taxpayer that sells must be the same taxpayer that purchases. If the entity is a true trust or a corporation, then it is important that the same entity acquire the replacement property. The situation is more complex when the nominee trust is considered a partnership for tax purposes or an individual or several individuals are considered to own the trust property for tax purposes.

If the nominee trust is a single owner entity and disregarded for federal income tax purposes, then the owner of the disregarded entity is the taxpayer. The sale of the trust’s property would then be listed on the owner’s income tax return. The owner could acquire the replacement property in his own name, or in the name of another disregarded entity, which could be a nominee trust (even with a different name) or a limited liability company owned by the individual.

If the nominee trust has multiple beneficiaries and is not a partnership, the advantage is that each beneficiary is free to decide whether or not to do a like-kind exchange or have a taxable sale. In this situation, each beneficiary should have his or her own Exchange Agreement with a qualified intermediary. Each beneficiary will be responsible to identify and acquire replacement property in the manner required by the Regulations.

If the nominee trust is considered a partnership, then the same partnership must acquire the replacement property. For tax purposes, the easiest situation is when the replacement property is acquired in the name of the same nominee trust, and the beneficiaries are the same individuals owning in the same shares. However, even a different trust may be used if the beneficiaries are the same individuals and they hold the same shares because this would be considered a continuation of the old partnership under a different name.

Changes in the beneficiaries’ interests, particularly the inclusion of new beneficiaries can be problematic. The easiest way to solve the exchange issue is to delay any changes of interest until after the replacement property is acquired. There are a number of solutions available when some partners want to cash out and other partners want to remain in the partnership. The partnership tax rules would determine how these transactions would be treated. Discussion of these rules is beyond the scope of this Article.
Conclusion

When a trust is involved in a like-kind exchange, the advisor needs to look at the Trust and how the beneficiaries have treated ownership of the property for federal income tax purposes. Using this information, the advisor can then determine the type of entity that is involved for federal income tax purposes in the exchange. Once this is determined, the advisor should then determine the beneficiaries’ plans once the property is sold in order to determine how best to structure the replacement leg of the exchange. While this can be relatively straightforward most of the time, differing objectives of the beneficiaries may present complex partnership tax issues requiring expert tax advice.

The following chart illustrates the identity of the taxpayer in many commonly occurring situations:

<table>
<thead>
<tr>
<th>TYPE OF TRUST</th>
<th>SPECIAL QUALITIES</th>
<th>TAX STATUS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nominee Trust-Agent</td>
<td>Single owner</td>
<td>The first “regarded” entity or person is the taxpayer.</td>
</tr>
<tr>
<td>Nominee Trust-Agent</td>
<td>Multiple beneficiary</td>
<td>If a partnership exists, the partnership is the taxpayer.</td>
</tr>
<tr>
<td>Nominee Trust-Agent</td>
<td>Multiple beneficiary</td>
<td>If no partnership exists, the beneficiaries are co-owners, and each co-owner is a separate taxpayer.</td>
</tr>
<tr>
<td>True Trust</td>
<td>Not a grantor trust</td>
<td>The trust is the taxpayer.</td>
</tr>
<tr>
<td>True Trust</td>
<td>Grantor trust</td>
<td>The grantors are taxpayers, and treated as co-owners.</td>
</tr>
<tr>
<td>Business Trust</td>
<td>Taxed as partnership or corporation</td>
<td>The business trust is taxpayer, unless it is considered a disregarded entity.</td>
</tr>
<tr>
<td>Business Trust</td>
<td>Disregarded entity</td>
<td>The single owner of the business trust is the taxpayer.</td>
</tr>
</tbody>
</table>
Reg. 301.7701-1(a)(1).

See Rev. Rul. 92-105, 1992-2 C.B. 207 for the tax treatment of Illinois land trusts as agents of the beneficiary in a like-kind exchange. While there is no similar ruling for Massachusetts nominee trusts, the common feature of control being vested in the beneficiaries indicates that the tax treatment should be the same.

See Reg. §301.7701-4(a).

See Rev. Rul 92-105, supra.

Reg. §301.7701-2(a). A business entity with two or more owners will be either a partnership or a corporation. A true tenant-in-common arrangement between co-owners of property is not considered a business entity.


See Bergford v. Commissioner, 12 F.3d 16, 169 (9th Cir., 1993).


This is a controversial area. While use of a partnership name is certainly a factor in determining the parties’ intent that a partnership exists under the facts and circumstances test, it is not the sole factor. See Sandoval v. Commissioner, T.C. Memo 2000-189 in which use of a common name was cited as an important factor.

Internal Revenue Code §761 and the Treasury Regulations thereunder allow co-owners of property in certain situations that could constitute a partnership for federal income tax purposes to “elect out” of Subchapter K and be taxed as co-owners (tenants-in-common) rather than as partners. The use of the so-called §761 election is limited. Certain circumstances can constitute a “deemed §761 election” under the Regulations, but this is rarely applied. The §761 election can be considered in co-ownership of property held as a passive investment as a protective election to help prevent later assertion that the arrangement was a partnership for federal income tax purposes. The §761 election appears to be used mainly by owners of working interests in oil and gas to avoid deemed partnership treatment.

See Internal Revenue Code §671, et seq.
