

API Legal and Tax Update

Trusts and 1031 Exchanges

Trusts are often involved in Internal Revenue Code (“IRC”) Section 1031 exchanges. For example, the relinquished property may be held in a revocable living trust that was formed for estate planning purposes. Or the replacement property may consist of an interest in a Delaware statutory trust or an Illinois land trust. All of these trusts, though serving different purposes, have certain common characteristics, and follow certain rules. Understanding these characteristics and rules can help overcome the challenges presented by trusts.

General Trust Principles

A trust consists of three parties: the trustee, the beneficiary(ies), and the grantor (often called other names like “settlor” or “trustor,” but “grantor” is the name favored by the IRC). The grantor forms the trust, usually pursuant to a written trust agreement, by transferring property to the trustee. The trustee holds legal title to the property for the benefit of the trust beneficiaries in accordance with the provisions of the trust agreement.

A trust may or may not be a regarded entity for tax purposes. If the grantor retains certain powers over the property after the grantor has contributed property to the trust, then the trust is a “grantor trust.” The retained powers which create a grantor trust are set forth in IRC Sections 671 — 677. A grantor trust is disregarded for tax purposes, and the grantor remains the owner of the property for tax purposes.

The most common retained power creating a disregarded grantor trust is the power of revocability (IRC Section 676). A revocable trust is always a grantor trust. An irrevocable trust may be a grantor trust if the grantor has retained some other power, such as the “power to control beneficial enjoyment” (IRC Section 674). If no other power has been retained by the grantor, an irrevocable trust will be a regarded taxpayer.

Who is the Taxpayer?

A question often raised when property is held in trust is “who is the taxpayer doing the exchange?” The trustee holds legal title to the property, so is the trustee the taxpayer? And the beneficiaries hold a beneficial interest in the property, but these are expressly excluded from exchanges under IRC Section 1031(a)(2)(E).

Actually, there are only two possible answers: (i) if the trust is an irrevocable trust where no other powers have been retained by the grantor (i.e., a non-grantor trust), then the trust is the taxpayer doing the exchange; or (ii) if the trust is a grantor trust (always the case for a revocable trust), then the grantor (the person who formed the trust and contributed property to the trust) is the taxpayer doing the exchange.



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These are the only possibilities. The taxpayer must be either the trust itself, or the grantor, and not the trustee (unless the trustee is also the grantor) or the beneficiaries.

Estate Planning Trusts

For decades, a popular tool used in estate planning has been the revocable trust, often called a living trust. This involves a grantor (an individual or a married couple) executing a trust agreement and transferring property to a trustee to be held in trust for the benefit of beneficiaries. The grantor and initial trustee are usually the same person.

Things start out simple: the revocable living trust starts as a grantor trust, disregarded for tax purposes. Things can get more complicated when grantors die. Upon the death of one or more of the grantors, irrevocable trusts may be created pursuant to the trust agreement. These trusts may be regarded taxpayers, and may seek to do exchanges with the property they hold.

Business Trusts

Trusts can also be formed for business purposes, such as Delaware Statutory Trusts and land trusts. Even though these trusts are formed for business purposes and not for estate planning purposes, the basic trust principles described above still apply.

Delaware Statutory Trusts

Delaware statutory trusts ("DSTs") are used to facilitate ownership of property by multiple owners. In a DST, a trustee holds legal title to a property, and investors can purchase "beneficial interests" in the trust. In Revenue Ruling 2004-86, the IRS determined that, because of the very limited powers of the trustee, the owners of the beneficial interests are treated as grantors of a grantor trust, and for tax purposes own fractional interests in the underlying property held by the trust. Therefore, a beneficial interest in a DST that owns real property is of like kind to a fee interest in real property.

Land Trusts

To create an Illinois land trust (or a comparable land trust under the statutes of several other states), an individual property owner transfers legal title to a trustee, who holds the property subject to a land trust agreement, with the individual retaining a beneficial interest in the property. The individual retains control of the management and operation of the property, and is responsible for all tax and other liabilities in connection with the property. In Revenue Ruling 92-105 the IRS determined that, because of the control retained by the beneficiary, the beneficiary's interest in the land trust constituted an interest in real property for exchange purposes.



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