Is Real Estate Held in Trust Eligible For I.R.C. §1031 Exchange Treatment?

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Overview

A significant amount of farm and ranch land is held in a trust. Trusts are a popular part of many farm and ranch (and other) estate plans. If farmland or ranchland is contained in a trust, is it still eligible to be exchanged for other real property and have the gain (or loss) on the transaction deferred under I.R.C. §1031? If so, that means that placing land in a trust for estate planning (or other) reasons doesn't eliminate the favorable tax consequences of I.R.C. §1031.

Whether real estate held in trust can qualify for like-kind exchange treatment – it's the topic of today's post.

Trusts and I.R.C. §1031 – The Basics

There is no absolute bar against a trust being part of an I.R.C. §1031 transaction. A trust can qualify if it otherwise satisfies the requirements of I.R.C. §1031. However, the taxpayer that owns the relinquished property must be the same taxpayer that takes ownership of the replacement property. This means that the taxpayer's identity must not change between the time of the relinquishment of the real estate and the time the replacement real estate is received.

With respect to a trust, the key determinations to be made are who (or what) is the taxpayer and whether the taxpayer's identity is preserved during the exchange process. A taxpayer's identity is not necessarily the same concept than the manner in which property is titled. Instead, the question is whether the entity holding title to the real estate (such as a trust) that is involved in an exchange preserves the taxpayer's identity. If the taxpayer's identity changes between the time the taxpayer relinquishes the property and the time the replacement property is received, the same taxpayer will not have disposed of and received property.

Grantor trusts. If the trust is a grantor trust, such as a revocable trust, *generally* the grantor, trustee and beneficiary are same person. Such a trust is a "tax disregarded" entity and all items of income, loss, deduction and credit and are taxed to the grantor. The trust does not file a return in addition to that of the grantor. Thus, the grantor can meet the is the taxpayer and the taxpayer's identity is preserved. This all means that a revocable living trust can be utilized as an ownership vehicle in a 1031 exchange - the grantor or trustee are considered the taxpayer. But, if the beneficiary is a different individual than the grantor, the beneficiary is not considered to be the taxpayer and cannot directly benefit from an I.R.C. §1031 exchange.

Non-grantor trusts. Conversely, if the trust is a non-grantor trust (such as an irrevocable trust where the grantor has not retained other powers), the trust is the taxpayer that is engaged in the like-kind exchange transaction. Unlike a revocable trust, an irrevocable trust has its own tax identification number and is not, for tax purposes, treated interchangeably with the grantor/settlor. But, an irrevocable trust can be a grantor trust if the grantor retains, for example, the "power to control beneficial enjoyment." *I.R.C. §674*.

"Illinois" Land Trust

An Illinois land trust is comparable to a revocable living trust that is used to hold real estate. It can be revoked or amended during the grantor's life. The trust's grantor/beneficiary retains all rights and responsibilities of owning the real estate. A land trust can only hold real estate interests, and the trustee is a professional trustee. A land trust is recognized in a minority of states - Florida, Georgia, Hawaii, Illinois, Indiana, Montana, South Dakota and Virginia.

For land held in a land trust, title to the real estate is held by the trustee as the owner of the trust, and the trust owner holds the beneficial interest in the trust that holds the title to the property. That created some uncertainty as to whether a land trust can be involved in an I.R.C. §1031 exchange because I.R.C. §1031 restricts the exchange of a beneficial interest in an asset. However, the IRS issued a Revenue Ruling in 1992 taking the position that an interest in an Illinois Land Trust is an interest in real property that can be exchanged for like-kind real estate. *Rev. Rul. 92-105, 1992-2 C.B. 204.* While a beneficiary's interest in a land trust was deemed to be personal property under state (IL) law, that characterization didn't control the outcome. The IRS looked at the facts of the particular situation and noted that the trustee was only acting at the discretion of the taxpayer (beneficiary). The trustee merely held title and could only potentially transfer that title. Thus, the trust was an agency relationship between the trustee and beneficiary involving the holding and transferring of the title to the real estate contained in the trust. The taxpayer/beneficiary retained the right to manage and control the trustee, and remained the direct owner of the property for tax purposes. It was the beneficiary that remained obligated to pay the taxes and other liabilities associated with the trust property, and it was the beneficiary that had the exclusive right to the trust property's earnings and profits. Based on those facts, the IRS determined that the beneficiary's interest in the trust was an interest in real property that could be exchanged for other real property and qualify for deferral of gain (or loss) via I.R.C. §1031.

The trust and the relationship of the parties in the 1992 ruling was not determined to be a partnership. If the IRS had determined that a partnership was involved, that would have meant that the beneficiary's interest in the real estate in the trust would not have qualified for like-kind exchange treatment – partnership interests are not eligible. Important to that point, only one beneficiary was involved under the facts of the ruling. With multiple beneficiaries, it may be easier for the IRS to asset that a partnership exists and deny I.R.C. §1031 eligibility.

Based on Rev. Rul. 92-105, if a trust (or similar arrangement created under state law) is merely an investment vehicle, it can qualify as like-kind to real property under I.R.C. §1031. That's certainly the case for a trust if the trustee has title to the real property in the trust; the beneficiary has the exclusive right to direct or control the trustee in dealing with title to the property; and the beneficiary has the exclusive control of the property's management as well as the obligation to pay any taxes and other liabilities that relate to the property. When those factors are present, an exchange transaction actually involves the exchange of the underlying trust property rather than an exchange of a certificate of trust beneficial interest, and the gain or loss on the transaction can be eligible for deferral under I.R.C. §1031.

Delaware Statutory Trust

Twelve years after Rev. Rul. 92-105, the IRS issued another revenue ruling on the issue. Rev. Rul. 2004-86, 2004-2 C.B. 191 involved a Delaware Statutory Trust (DST) that was formed to hold real property subject to a lease. A DST is a form of business trust where the owner of a DST share is regarded as owning a beneficial interest in the trust. Under the facts of the Rev. Rul., the trustee's powers were limited to only collecting and distributing income. As such, the DST was merely an investment trust and its interests could be exchanged for real property in an I.R.C. §1031 transaction. Specifically, Rev. Rul. 2004-86, stands for the proposition that a DST can be utilized for the purchase of replacement property in an I.R.C. §1031 exchange. However, with more retained powers in the trustee, the IRS said that the trust would be a business trust rather than an investment trust and would not qualify for like-kind treatment. Consequently,

Rev. Rul. 2004-86 is quite limited. But, if all of the interests in the trust are of a single class that represent undivided beneficial interests of the trust and the trustee cannot vary the trust's investments, the trust will be an investment trust and its assets can be exchanged for real property with any gain qualifying for deferral under I.R.C. §1031. On the other hand, if the trustee has greater discretion with respect to the trust property, those additional powers could cause disqualification from I.R.C. §1031 treatment. Those additional powers could include, for instance, the power to dispose of the real property in the trust and acquire new property, the power to renegotiate leases on the trust property, or approve more than minor modifications or improvements to the property. If those powers are present, the IRS could take the position that the trust constitutes a business entity not eligible for I.R.C. §1031 treatment.

Perhaps the most important aspect of Rev. Rul. 2004-86 is that the IRS at least impliedly classified the DST as a grantor trust. Thus, real estate contained in a grantor trust could be exchanged for interests in a grantor trust containing real property and the transaction would qualify for deferral treatment under I.R.C. §1031. That has important estate planning implications.

Safe Harbor for Trusts Holding Rental Real Estate

An arrangement with a single class of ownership interests, representing undivided beneficial interest in the trust assets, is classified as a trust if there is no power under the trust agreement to vary the investment of the beneficiaries ("power to vary"). *Treas. Reg. §301.7701-4(c).* As noted above, in Rev Rul. 2004-86 the IRS took the position that a DST formed to hold real property subject to a lease was an arrangement classified as a trust for Federal tax purposes under Treas. Reg §301.7701-4(c). However, the trust would be a business entity and not a trust if the trustee had a power to, among other things, renegotiate the lease with the tenant, to enter into leases with other tenants, or to renegotiate or refinance the mortgage loan whose proceeds were used to purchase the real estate.

After the issuance of Rev. Rul. 2004-86, the IRS provided safe harbors for determining the Federal income tax status of certain securitization vehicles that hold mortgage loans. Under the safe harbors, certain modifications of mortgage loans in connection with forbearance programs described in that guidance are not treated as manifesting a power to vary. When those safe harbors were issued, the IRS received comments addressing arrangements organized as trusts under Treas. Reg. §301.7701-4(c), and Rev. Rul. 2004-86 that hold rental real property. As a result, the IRS in 2020 provided additional guidance detailing actions that will not constitute a power to vary for purposes of determining whether the arrangement is treated as a trust under Treas. Reg. §301-7701-4(c) and Rev. Proc. 2020-34, Sec. 7. *Rev. Proc. 2020-26, I.R.B. 753.* Section 6 of the safe harbor allows these arrangements to make certain modifications to their mortgage loans and their lease agreements and to accept additional cash contributions without jeopardizing their tax status as trusts.

Specifically, under Rev. Proc. 2020-26, the following do *not* constitute a power to vary in violation of the regulation: 1) modification of one or more mortgage loans that secure the trust's real property in a CARES Act forbearance or a forbearance that the trust requested, or agreed to, between March 27, 2020, and December 31, 2020, and that were granted as a result of the trust experiencing a financial hardship due to the actions of state governments in reaction to the China-originated virus; 2) modification of one or more real property leases entered into by the trust on or before March 13, 2020, where the modifications were requested and agreed to on or after March 27, 2020 and on or before December 31, 2020, and the reason for the lease modification is to coordinate the lease cash flows with the cash flows that result from one or more transactions described in the Notice or to defer or waive one or more tenants' rental payments for any period between March 27, 2020 and December 31, 2020 because the tenants are experiencing a financial hardship due to the COVID-19 emergency; and 3) the acceptance of cash contributions that were made between March 27, 2020, and December 31, 2020, as a result of the trust experiencing financial hardship due to state government conduct in reaction to the China virus. However, the contribution must be needed to

increase permitted trust reserves, to maintain trust property, to fulfill obligations under mortgage loans, or to fulfill obligations under real property leases. A cash contribution from one or more new trust interest holders to acquire a trust interest or a non-pro rata cash contribution from one or more current trust interest holders must be treated as a purchase and sale under I.R.C. §1001 of a portion of each non-contributing (or lesser contributing) trust interest holder's proportionate interest in the trust's assets.

Conclusion

For real property contained in trust, if the trustee's powers are limited, the real property can be exchanged for other real property and qualify for gain (or loss) deferral under I.R.C. §1031. Land contained in a grantor trust is deemed to be owned by the individual grantor and remains eligible for I.R.C. §1031 treatment. For land contained in a non-grantor trust, the language of the trust is critical. For non-grantor trusts, the trust language must place sufficient limitations on the trustee's powers to allow the trust beneficiary to receive like-kind exchange treatment under I.R.C. §1031.

The virus-related relief granted in 2020 is also helpful for providing guidance on the "power to vary" issue.

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