



## THE SAME TAXPAYER REQUIREMENT

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In a 1031 exchange transaction, it is often said that legal title to the real estate being sold (i.e., the relinquished property) and the real estate being purchased (i.e., the replacement property) must be held or owned under the exact same legal title. This is a common misconception and is not accurate. Although it is generally recommended to hold the legal title to all properties in a 1031 exchange under the exact same legal title, there are exceptions where legal title is not required to be identical.

### Same Taxpayer Requirement

The actual requirement is that the ownership (i.e., the taxpayer) of the relinquished properties and replacement properties in a 1031 exchange must be held or owned by the “same taxpayer” regardless of how legal title is held. The same taxpayer must sell the relinquished properties and buy the replacement properties.

This same taxpayer requirement is an implicit requirement that is not specifically mentioned in the Internal Revenue Code or Treasury Regulations. Legal title may vary from the sale of the relinquished property to the purchase of the replacement property if the property ownership continues to be held or owned by the exact same taxpayer.

This is just one of many reasons why investors should always discuss their proposed 1031 exchange with their legal, tax and financial advisors before proceeding with their transaction.

### Exceptions – Disregarded Entities

There are several ways in which an investor can acquire and hold legal title to real estate while still meeting the same taxpayer requirement. Generally, this is achieved using a disregarded entity. Disregarded entities are entities that are ignored for Federal income tax purposes (i.e., they do not file a Federal tax return) and are treated as if the underlying investor is the actual owner (i.e., taxpayer).

The following are either individuals or disregarded entities that will be treated as if the properties were owned or held by the same taxpayer:

- the investor’s individual name
- a single-member limited liability company that has not elected to be treated as a partnership or corporation for Federal income tax purposes (i.e., it is a disregarded entity)
- a fully revocable grantor trust (e.g., living trust)
- a title holding trust (land trust) pursuant to Revenue Ruling 92-105
- a tenant-in-common (TIC) ownership structure pursuant to Revenue Procedure 2002-22
- a Delaware Statutory Trust (DST) pursuant to Revenue Ruling 2004-86.

### Examples Using Disregarded Entities

Lenders often require the legal title of the replacement property to be held in a specific way for them to complete the financing for the purchase of the replacement property. Many lenders do not allow legal title to be held in a trust or a limited liability company, while other lenders may require legal title to be held in a limited liability company.



For instance, an investor may hold legal title to his or her relinquished property in a limited liability company, but the lender may insist that legal title to the replacement property be held in the investor's individual name to complete the financing. This will meet the same taxpayer requirement if the limited liability company is a single-member limited liability company and disregarded entity for Federal income tax purposes. The limited liability company is ignored and treated as if the underlying individual is the owner for Federal income tax purposes and therefore considered to be the same taxpayer.

Similarly, an investor may hold legal title to his or her relinquished property in a fully revocable grantor trust (i.e., living trust, title holding trust or land trust), but the lender may require legal title to the replacement property be held in the investor's individual name to complete the financing. This will also meet the same taxpayer requirement if the trust is a disregarded entity for Federal income tax purposes. The trust is ignored and treated as if the underlying individual is the owner for Federal income tax purposes and therefore considered to be the same taxpayer.

In some situations, legal title to the relinquished property might be held in the name of only one spouse, and the investor may wish to add his or her spouse to the legal title of the replacement property, or the lender may require the spouse be included on legal title to the replacement property. Whether this will be considered the same taxpayer will depend on several factors, including the state in which the investors reside.

#### **Death of Taxpayer During 1031 Exchange**

If the taxpayer dies during a 1031 exchange, the Treasury Regulations require the estate of the taxpayer to complete the 1031 exchange transaction to receive tax-deferred exchange treatment. In fact, the estate of the taxpayer must complete the 1031 exchange to receive a step-up in the cost basis.

The 1031 exchange must have already been set-up and the sale of the relinquished property must have already closed prior to the taxpayer's death for this rule to apply. Although the taxpayer and his or her estate are not considered to be the same taxpayer, the Treasury Regulations allow this exception to the same taxpayer requirement.

#### **Non-Disregarded Entities**

Entities that are not classified as disregarded entities for Federal income tax purposes (i.e., they are regarded entities), include, but are not limited to:

- Limited liability companies treated as a partnership or a corporation
- General partnerships
- Limited partnerships
- Corporations (both sub-chapter "C" and "S" corporations)
- Irrevocable trusts

Legal title to the relinquished and replacement properties must generally be held in the exact same legal title (i.e., in the regarded entity name) when the entity is not disregarded for Federal income tax purposes.

#### **Legal, Tax and Financial Advisor Review**

The requirement of having the same taxpayer vs. the way legal title is held can be very complex. It is therefore crucial for investors to have their legal, tax, and financial advisors examine their proposed 1031 exchange transaction prior to completion to ensure that the same taxpayer requirement is met. If the taxpayer is not deemed to be the same, the 1031 exchange could be disallowed.