

## Vesting Issues with a 1031 Exchange

For an exchange to satisfy IRC §1031, the taxpayer that will hold the title to the Replacement Property must be the same taxpayer that held title to the Relinquished Property. However, business considerations, liability issues, and lender requirements may make it difficult for the Exchanger to keep the same vesting on the Replacement Property. Exchangers must anticipate these vesting issues as part of their advanced planning for the exchange.

There are some exceptions to this rule when dealing with entities that are disregarded for federal income tax purposes. For example, the following changes in vesting usually do not destroy the integrity of the exchange:

- The Exchanger's revocable living trust or other grantor trust may acquire Replacement Property in the name of the Exchanger individually, as long as the trust entity is disregarded for Federal tax purposes. Rev. Rul. 2004-86.
- The Exchanger's estate may complete the exchange after the Exchanger dies following the close of the sale of Relinquished Property. Rev. Rul. 64-161.
- The Exchanger may sell Relinquished Property held individually and acquire Replacement Property titled in a single-member LLC or acquire multiple Replacement Properties in different single-member LLCs as long as the Exchanger is the sole member and the single member LLCs are treated as disregarded entities. PLR 200732012.
- A married couple may exchange Relinquished Property held individually as community property for Replacement Property titled in a two-member LLC in which the married couple's ownership is community property, but only in community property states and only if they treat the LLC as a disregarded entity. Rev. Proc. 2002-69 as amended by Rev. Rul. 2013-17.
- A corporation that merges out of existence in a tax-free reorganization after the disposition of the Relinquished Property may complete the exchange and acquire the Replacement Property as the new corporate entity. TAM 9252001, PLR 200151017.
- An Illinois land trust is a disregarded entity for IRC §1031 purposes, so an Illinois land trust beneficiary may exchange his beneficial interest in Relinquished Property held by the trust for Replacement Property vested in the beneficiary individually, or in a different Illinois land trust, as long as the Exchanger is the beneficiary. Rev. Rul. 92-105.

Adding a party to vesting, such as when the Relinquished Property is owned by one spouse and the Replacement Property will be acquired by both spouses, could result in partial recognition of gain by the spouse on title to the Relinquished Property. Divesting Relinquished Property held in one entity, such as a corporation, partnership, or multi-member LLC and acquiring the Replacement Property in a different corporation, partnership, or multi-member LLC, or in the shareholders, partners or members individually, will disqualify the exchange because the exchange is being completed by a different taxpayer than the one starting the exchange. However, conversion of a general partnership to an LP or an LLC during the Exchange Period will not disqualify the exchange. PLR 99935065.



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## Vesting Issues for Spouses

Occasionally, spouses who file joint tax returns want to add the other spouse to the title of their replacement property. This presents an open issue and taxpayers should seek the counsel and assistance of their tax and legal advisors with regard to how they should proceed.

The last ruling from the IRS was in TAM8429004 which was based on law which preceded the enactment of Section 1041 (which permits unlimited tax-free gifting between spouses). In TAM8429004, which involved Section 1033, the IRS held that where both spouses were on title to the relinquished property (RQ) but only husband was on title to the replacement property (RP), the wife gifted her portion of the proceeds and must pay tax on 50% of the gain.

Since it is an open issue, the most conservative approach would be to keep the vesting unchanged. For example, if both spouses are on title to the RQ, both should be on title to the RP in both common law and community property states.

However, if changes are made, below are some potential scenarios and possible solutions to be considered after consulting with tax and legal advisors.

### Scenarios

1. One spouse on title to RQ but lender wants both on title to RP.

#### *Potential Solution?*

Have legal counsel prepare an agreement that the co-signing spouse is doing so in trust for the other spouse; that the RP is separate property of other spouse and that no gift has occurred.

2. If there is no lender requirement only spouse on title to RQ should be on title to RP. This can be a concern for the spouse not on the title.

#### *Potential Solution?*

Can put title to the RP in a revocable living trust with the other spouse being the beneficiary to protect from an untimely death until they can safely be added to title.

3. If both spouses are on title on title to the RQ but the lender only wants one on title to the RP, there may be a problem.

#### *Potential Solution?*

May need to find a new lender or rely on the application of Section 1041.

To avoid disqualifying the exchange, the Exchanger should not make any changes in the vesting of the Relinquished or Replacement Properties prior to or during the exchange. Exchangers are cautioned to consult with their tax or legal advisors regarding how their vesting issues will impact the structure of their exchange before they transfer the Relinquished Property. Proper planning and negotiation can make the difference between a successful exchange and a taxable problem.



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