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Neil E. Harl
Iowa State University

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Can Trust Beneficiaries Use Section 1031 Like-Kind Exchanges?

-by Neil E. Harl

A recurring question – can beneficiaries of trusts utilize the like-kind exchange procedure available since 1918? The framework for making that decision rests primarily upon a series of relatively recent rulings issued by the Internal Revenue Service.

Rev. Rul. 92-105

Rev. Rul. 92-105 posed the issue rather succinctly – does a taxpayer’s interest in an Illinois Land Trust constitute real property which may be exchanged for other real property without recognition of gain or loss under section 1031 of the Internal Revenue Code? Under Illinois law, a beneficiary of a land trust is characterized as personal property. However, the beneficiary of a land trust also possesses several key features including the fact that the beneficiary (or anyone designated by the beneficiary) has the exclusive power to direct or control the trustee in dealing with the title to the property in the land trust, the beneficiary has the exclusive control of the management of the property and the beneficiary has the exclusive right to the earnings and proceeds from the property.

That collection of features was sufficient for IRS to rule that a beneficiary’s interest in an Illinois land trust is an interest in real property which could be exchanged for other real property without recognition of gain or loss under Section 1031 of the Internal Revenue Code.

More importantly, the ruling proceeded to broaden the scope of the ruling result in stating that –

“The holding in this revenue ruling also applies to an interest in a similar arrangement created under the laws of any state, pursuant to which (1) the trustee has title to real property, (2) the beneficiary (or a designee of the beneficiary) has the exclusive right to direct or control the trustee in dealing with the title to the property, and (3) the beneficiary has the exclusive control of the management of the property, the exclusive right to the earnings and proceeds from the property, and the obligation to pay any taxes and liabilities relating to the property.”

* Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar.
The ruling concludes that, because the trustee’s only responsibility was to hold and transfer title at the direction of the beneficiary, a trust was not established. Thus, the exchange of real property was an exchange of the underlying property, not an exchange of a certificate of trust of beneficial interest, and the exchange was like-kind.  

Rev. Rul. 2004-86

In 2004, IRS revisited the issue and published Rev. Rul. 2004-86. Under that ruling, the question was whether a taxpayer could exchange real property for an interest in a Delaware statutory trust without recognition of gain or loss under Section 1031 of the Internal Revenue Code. Under Delaware law, a Delaware statutory trust is an unincorporated association recognized as an entity separate from its owners. Creditors of the beneficial owners may not assert claims directly against the property in the trust. Also, a Delaware statutory trust may sue or be sued, and property held in such a trust is subject to attachment or execution as if the trust were a corporation. Beneficial owners of Delaware statutory trusts are entitled to the same limitation on personal liability as is extended to corporate shareholders.

The ruling concludes that the trust in question was an investment trust rather than a business trust. The beneficiaries were considered to hold an undivided fractional interest in the property held by the trust so the exchange of real property through a qualified intermediary was the exchange of real property for real property and not the exchange of real property for a certificate of trust.

The ruling cautions that, if the Delaware statutory trust was classified as a business entity, the outcome would be different. The ruling points out that the entity would be classed as a business entity if the trustee had the power to dispose of the real property and acquire new property, renegotiate leases, renegotiate or refinance the purchase obligation received cash received to profit from market fluctuations or make more than minor non-structural modifications to the real property that is not required by law.

In conclusion

The opportunity for trust beneficiaries to exchange their proportionate part of trust real property for other real property and to be eligible for like-kind exchange treatment without gain or loss recognized thus depends upon the extent to which the trustee’s powers are limited. The 1992 ruling, Rev. Rul. 92-105, continues to be the starting point in determining eligibility for such exchanges but should be read in conjunction with Rev. Rul. 2004-86. It is clear that, if it is desired for trust beneficiaries to be eligible to exchange interests in property in a like-kind exchange, care in drafting of the trust instrument is vital.