IRS CONCLUDES TRUST DISTRIBUTION PRIOR TO SALE DOES NOT VIOLATE LIKE-KIND EXCHANGE "HELD FOR" REQUIREMENT

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Internal Revenue Code Section 1031 allows taxpayers to defer federal income tax on the sale of real estate (relinquished property) if the sales proceeds are reinvested in business or investment real estate (replacement property) (a "like-kind exchange"). One of the requirements of a valid like-kind exchange is that both the relinquished and replacement properties be acquired and "held for productive use in a trade or business or for investment" (commonly referred to as the "held for" requirement). Neither the Internal Revenue Code nor the Treasury Regulations specify the length of time the properties must be held to satisfy this requirement but the position of the IRS has been that if a taxpayer acquires the relinquished property shortly prior to the exchange or if the replacement property is disposed of shortly after the exchange, the property was not held for the required purpose and the "held for" requirement is not met.

A "drop and swap" transaction allows the owners of an entity which holds qualifying real estate to separately decide whether they wish to pursue a like-kind exchange or cash out. In the "drop", the entity which owns the real estate distributes the ownership of the underlying real estate to its owners in the form of tenancy-in-common interests. In the "swap", the owners who wish to effect a like-kind exchange use the proceeds from the sale of their tenancy-in-common interests to "swap" into (i.e., purchase) replacement property to complete the exchange. The other owners simply retain their share of the proceeds and pay tax on their gain. There have been several IRS rulings that have disqualified like-exchanges, reasoning that the "held for" requirement had not be met because the "drop and swap" occurred too close in time.

In the recently issued Private Letter Ruling 202416012, the IRS considered whether a distribution of an undivided tenancy-in-common interest (the "TIC Interest") in real estate by a trust to its beneficiaries as a result of a trust's involuntary termination precluded the TIC Interest from satisfying the "held for" requirement when the TIC Interest was subsequently sold by the beneficiaries. The ruling involved a testamentary trust that held investment real estate in which the taxpayer was the beneficiary. The terms of the trust provided that the trust would terminate upon the death of the last surviving child of the decedent's daughters who was living at the decedent's death. Upon the terminating event, the trustees were required to distribute the trust assets to the beneficiaries.

Prior to the terminating event, the trustees intended for the trust to engage in a like-kind exchange of the trust real estate. During negotiations with a potential buyer, the terminating event occurred. The trustees completed negotiations for the sale of the trust real estate but determined that it was no longer feasible for the trust itself to consummate a like-kind exchange. As part of the termination plan, and with the probate court's permission, the trustees would accommodate any beneficiaries interested in completing the contemplated like-kind exchange. The trustees then distributed TIC Interests in the real estate to the exchanging beneficiaries' disregarded entities so that the beneficiaries wishing to do so could engage in separate like-kind exchanges.

After comparing the facts of the ruling to older revenue rulings in which the IRS concluded that the like-kind exchanges did not qualify for nonrecognition treatment, the IRS ruled that the distribution of the TIC Interest to the taxpayer's disregarded entity did not preclude the interest from satisfying the "held for" requirement at the time of the subsequent sale. The IRS noted that the termination event occurred after the trust had held the real estate for many years and the terminating event could not be modified or changed. The IRS also noted that the termination plan was anticipated to be approved by the probate court and would be implemented without regard to whether the like-kind exchange of the taxpayer's TIC Interest for eligible real estate was completed. Based on these facts, the IRS determined that the distribution of the taxpayer's TIC Interest was wholly independent of the taxpayer's proposed like-kind exchange and distinguishable from the older revenue rulings which involved voluntary transfers of properties pursuant to prearranged plans. In other words, the IRS viewed the real estate as satisfying the "held for" requirement in the hands of the beneficiaries as it was in the hands of the trust.

Although a private letter ruling may only be relied on by the taxpayer who requests the ruling, PLR 202416012 is noteworthy because it suggests that "drop and swap" transactions involving involuntary transfers of real estate might not preclude taxpayers from satisfying the "held for" requirement. This analysis could also be relevant to entities other than trusts (e.g., partnerships and corporations) that engage in like-kind exchanges. The ruling may be particularly relevant to estate planning professionals because it confirms that trust beneficiaries may potentially continue to engage in like-kind exchanges even if the trust is unable to complete the transaction due to its termination.

If you have any questions regarding this alert, please contact your Cummings & Lockwood private clients attorney.