

## Trusts and Like-Kind Exchanges

**Take-Away:** It may be possible for a trust to distribute a tenant-in-common interest to a trust beneficiary and have that interest qualify for a *like-kind* exchange.

**Background:** The Tax Code provides that there is no gain or loss recognized on the exchange of real property that is held for productive use in a trade or business or for investment, **if** the property is exchanged solely for property of a *like-kind* which is held either for productive use in a trade or business or for investment. [IRC 1031(a)(1).] *Like-kind* is defined as referring to the nature or character of the property, not to its grade or condition. The fact that the real estate involved in the exchange is improved or unimproved is not material. In short, *like-kind* relates only to the real property's kind or class, not its grade or quality. [Regulation 1.1031(a)-1(b).]

**Holding Requirement:** There is thus a *holding* requirement under IRC 1031. It requires that both the relinquished real property and the replacement real property be *held* for productive use in a trade or business or *held* for investment. This requirement is designed to postpone the recognition of gain or loss when the real property used in a trade or business or *held* for investment is exchanged for other property while continuing that trade or business.

**No Termination:** Accordingly, the real property owner is not considered to have recognized a gain nor suffered a loss in a general and economic sense, nor has the exchange of real property resulted in the termination of one business venture and an assumption of a new business venture. Inherent in this rule is the assumption that the 'new' real property is substantially a continuation of the 'old' investment property which is still unliquidated.

**Questions:** What happens if a trust owns real property and it distributes the real property, or an interest in the real property, to a trust beneficiary? Will that a gain recognition event? Is that distribution a termination (not a continuation) for purposes of the *like-kind* exchange rule?

**Trust Termination:** The Regulations provide that the determination of whether a trust has *terminated* depends upon whether the real property held in trust has been distributed to the persons entitled to succeed to the real property upon termination of the trust rather than upon the technicality of whether the trustee has rendered a final accounting. [Regulation 1.641(b)-3(b).] A trust does not automatically terminate upon the happening of the event by which the duration of the trust is measured. Rather, a reasonable time is permitted after such event for the trustee to perform the duties necessary to complete the administration of the trust. The trust will be considered as *terminated* for federal income tax purposes after the expiration of a reasonable period for the trustee to complete the administration of the trust.

A recent Private Letter Ruling addressed a terminating trust's distribution of an undivided tenant-in-common interest in real property to a trust beneficiary subject to a binding contract for its disposition in conjunction with a *like-kind* exchange. The result turned on the trust's *involuntary termination*.

***Private Letter Ruling 105745-24 (September 16, 2024)***

**Facts:** The decedent died with a testamentary trust. The trust was created for the benefit of the decedent's daughters. On the decedent's death undeveloped land was transferred to the trust. The trust continued to own the land at the time of the PLR. The trust was to terminate upon the death of the last surviving child of the settlor's two daughters who was living at the time of the decedent's death. At the trust's termination, the trustee was directed to distribute the trust corpus to the remainder beneficiaries. The trust beneficiaries were prevented under the trust from their ability to assign their interests in the trust or its corpus.

**1031:** After a several years the trustee decided to better preserve the trust's corpus, that it would be in the best interests of the trust beneficiaries to engage in a like-kind exchange under IRC 1031 of the trust's undeveloped land, to be replaced with other real properties. While negotiations were taking place, but before a contract of sale was signed for the sale of the trust's undeveloped land by the trustee, a terminating event under the trust instrument occurred on the death of the individual who was the last surviving child of the settlor's daughters. The trustee completed the negotiations with the buyer to dispose of the

land. However, the trustee determined at that time, that it was no longer feasible for the trust to consummate a 1031 *like-kind* exchange of the land for other real properties because of the trust's terminating event.

**Termination Plan:** The trustee then informed the trust's remainder beneficiaries of the trustee's intent to request a state court order to approve the disposition of the land as part of the overall approval of the trust's termination plan. As part of the termination plan the trustee agreed to accommodate any remainder beneficiaries who were interested in completing the exchange in the manner that the trustee had initially contemplated prior to the trust's terminating event. The trust remainder beneficiaries informed the trustee of their desire to complete the exchange of the land.

**LLCs:** To implement the distributions, LLCs were formed and owned separately by each trust remainder beneficiary. Each LLC was to be disregarded as an entity separate from its sole member. Following the creation of the LLCs, the trustee would then make distributions of appropriate undivided tenant-in-common interests in the land, subject to the sales contract, to each exchanging beneficiary's LLC. After distribution of the tenant-in-common interests in the land, each beneficiary, through his/her separate LLC, would engage in a separate *like-kind* exchange transaction.

**IRS Ruling:** The terminating event as defined in the trust instrument occurred many years after the trust came into existence. The trust was a testamentary trust; accordingly, the terminating event was fixed by the decedent, and it could not be modified or changed. Because the LLCs will be disregarded as entities separate from the trust remainder beneficiaries, the distribution of the tenant-in-common interests by the trust to the LLCs will be considered for federal income tax purposes as a distribution of the tenant-in-common interests directly to the trust remainder beneficiaries individually. The trust's distribution of a trust remainder beneficiary's tenant-in-common interest, pursuant to the court approved termination plan, will be wholly independent of the proposed 1031 exchange. Therefore, the IRS held:

The trust's distribution plan to each trust remainder beneficiary's tenant-in-common interest, subject to the sales contract, because of the trust's *involuntary termination*, will

not preclude the tenant-in-common interest from being held for investment or the productive use in a trade or business.

The remainder beneficiary's exchange of his/her tenant-in-common interest is independent of the trust's *involuntary termination*. Consequently, the transfer of a tenant-in-common interest in the undeveloped land to the remainder beneficiary's LLC subject to a contract for its disposition will not violate IRC 1031(a)'s *holding* requirement with respect to the proposed *like-kind* exchange.

**Conclusion:** The 2017 Tax Act eliminated *like-kind* exchanges for property other than real estate. Under the Biden Administration, several proposals were offered to eliminate *like-kind* exchanges for real estate, but those proposals went nowhere. It's probably that IRC 1031 will remain as part of the Tax Code. This PLR is an interesting example of how the distribution of tenant-in-common interests in real property to trust beneficiaries on the trust's termination can also benefit from a *like-kind* exchange.

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