Disregarded Entity Issues

"Important to Review these Issues with a Tax Advisor"

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This flyer summarizes rules relating to entities that may be "disregarded" for purposes of IRC Section 1031 and is designed to assist in cases where the Exchanger desires to title the replacement property in a manner that is different from title to the relinquished property. In all cases, an Exchanger should consult with their tax or legal advisor to ensure that the desired structure is acceptable for IRC Section 1031 purposes.

GENERAL RULES

1. Virtually any natural or legal person (individual, corporation, partnership, LLC, trust, etc.) may do an IRC Section 1031 exchange.
2. The seller of the relinquished property (generally as determined by the status of legal title) must also be the buyer of the replacement property, e.g., if John Q. Public is on title to the relinquished property, then John Q. Public must acquire title to the replacement property.

EXCEPTION TO RULE 2

If the transferor of the relinquished property or the transferee of the replacement property is a "disregarded entity" (See Treas. Reg. § 301.7701) or the "owner" of a disregarded entity, then the entity is treated as if it does not exist and the owner and the entity are, in effect, interchangeable as the Exchanger, i.e., the entity may sell and the owner may buy and vice versa. For example, if A owns 100% of the interests in an entity that is a "disregarded entity" then A may sell the relinquished property and the entity may take title to the replacement property and vice versa.

WHAT ENTITIES ARE NOT DISREGARDED?

- C ("regular") Corporations:Not disregarded
- S Corporations: Not disregarded
- General Partnerships: Not disregarded
- Limited Partnerships: Not disregarded

The IRS has ruled that where an otherwise non-disregarded entity has two members under local law, but one of the members is a disregarded entity that is owned by the other member, the eligible entity is treated as having only one member. Thus, the entity cannot be a partnership for tax purposes; it must be classified either as a disregarded entity or as an association taxable as a corporation. [Rev. Rul. 2004-77, 2004-31 I.R.B. 119]

LIMITED LIABILITY COMPANIES (LLCs)

LLCs are not disregarded except in the following cases where the LLC has **not** made an election to be treated for tax purposes as a corporation:

- 100% of the interests are owned by a single legal or natural person. [PLRs 9751012; 9807013; 19911033]
- 100% of the interests are owned by husband and wife as community property in a community property state. [Rev. Proc. 2002-69, 2002-2 CB831]

The IRS has ruled that a two-member LLC formed under Delaware law was disregarded for §1031 exchange purposes where all economic interests were held by one member and the function of the second member was solely to prevent a bankruptcy filing or other violation of the LLC's covenants with lenders [PLR 199911033]. The IRS has ruled that the acquisition of all the ownership interests held by 2 different owners by a single buyer in a single transaction constituted an acquisition of the underlying assets owned by the LLC. [Rev. Rul. 99-6, 1991-1 C.B 432].

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