Because of advantageous tax treatment combined with liability protection, limited liability companies (LLCs) have become a preferred way to own real estate in the United States. By understanding their structure, they can also be used to provide flexibility in complying with the requirements of a §1031 exchange. All 50 states have enacted laws permitting the formation of LLCs, including single member LLCs. Although they are separate entities from their owners and/or managers for legal and liability purposes, they may be disregarded entities for federal tax purposes. That means that although the member of a single member LLC is insulated from liability from the LLC’s activities, the sole member is considered to be the taxpayer for federal tax purposes. This creates planning opportunities for §1031 exchanges.

For federal tax purposes, an LLC is characterized as one of the following: a sole proprietorship (which reports income on a Schedule C, D, E or F to an individual’s Form 1040); a partnership (which reports income on Form 1065); or a corporation (which reports income on Form 1120 or Form 1120-S). If the LLC makes no election with the IRS to be taxed as a corporation, by default, a single member LLC is considered to be a sole proprietorship and therefore is disregarded from its member for federal tax purposes.

Similarly, an LLC with two or more members that makes no election with the IRS (to be taxed as a corporation) is considered to be a partnership for federal tax purposes. An exception to this rule is provided by Rev. Proc. 2002-69, which holds that the IRS will consider an LLC owned solely by a husband and wife as community property to be a disregarded entity. This only applies in the nine “community property states” which are: Louisiana; Texas; New Mexico; Arizona; California; Nevada; Washington; Idaho; and Wisconsin. An LLC owned solely by husband and wife would be considered to be a partnership in the 41 non-community property (common law) states and should file a Form 1065.

As stated above, an LLC (either single member or multi-member) can make an election with the IRS to be treated as a corporation for tax purposes. If desired, the LLC can make a further election to be treated as an S corporation instead of a C corporation. In summary, an LLC with only one owner will be classified as a disregarded entity or a corporation; whereas an LLC with two or more members will be classified as a partnership or a corporation (unless it is a husband and wife LLC in a community property state).

The use of disregarded entities can be helpful in resolving challenges which may be presented by the vesting requirements for a valid §1031 exchange; i.e. the Replacement Property must be acquired by the same taxpayer that disposed of the Relinquished Property. Although there are other disregarded entities such as Delaware Statutory Trusts (Revenue Ruling 2004-86), Delaware business trusts, Massachusetts nominee trusts, Illinois land trusts (Revenue Ruling 92-105), and grantor trusts; the use of single member LLCs is probably the most common in connection with §1031 exchanges.

Treasury regulation §301.7701-3(b)(1) provides that single member LLCs that acquire property are ignored for federal tax purposes and that the member is treated as the direct owner of the property. The IRS has issued Private Letter Rulings holding that the disposition of the Relinquished Property (or acquisition of the Replacement Property) by a disregarded entity of the taxpayer will be treated for purposes of §1031 as a direct disposition or acquisition of the asset by the taxpayer. PLRs 9807013, 200732012 and 201216007. The key to understanding the use of disregarded entities in a §1031 exchange context is the identification of the taxpayer. To have a valid §1031 exchange, the same taxpayer must sell the Relinquished Property and acquire the Replacement Property. For example, assume a taxpayer wants to exchange a Relinquished Property that he owns individually; but he wants to acquire the Replacement Property in a single member LLC to protect himself from liability. Because of the disregarded treatment of single member LLCs for tax purposes, this is not a problem.

Lenders frequently require that the Replacement Property be purchased in a “bankruptcy remote” entity. In addition, an Exchanger may be concerned about contingent liability relating to the selling entity and does not want take a chance that the Replacement Property might become subject to a future judgment related to the Relinquished Property or its nominal owner. In both of these situations, a disregarded single member LLC is very useful. A new single member LLC can be created to acquire the Replacement Property with the taxpayer that owned the Relinquished Property (individual, partnership, corporation, LLC, etc.) being the sole member of the new LLC.

Finally, it should be noted that the IRS has ruled that the acquisition of the membership interest in a disregarded entity holding the Replacement Property is treated (for §1031 purposes) as the acquisition of the Replacement Property. PLR 200118023. This may avoid double transfer taxes in some states, particularly in reverse exchanges involving parking arrangements. For example, assume the Replacement Property is being held by an Exchange Accommodation Titleholder (EAT) in a disregarded single member LLC. Acquiring the Replacement Property through assignment of the membership interest of the LLC will satisfy the exchange and may not trigger transfer taxes in states in which transfer taxes are assessed upon recording of a deed, but not upon transfer of membership interest.