

1031 DROP AND SWAP: BREAKING UP IS HARD TO DO

By: Gary Kravitz, Esq.

I. **THE BASICS OF 1031 EXCHANGES AND THE USE OF LIMITED LIABILITY COMPANIES IN REAL ESTATE ACQUISITIONS**

A. What is an IRC Section 1031 Like-Kind Exchange?

1. It is a tax-deferred exchange where a taxpayer sells one or more assets held for productive use in a trade or business or for investment (“Relinquished Property”) and re-invests all of the sales proceeds into new assets of a “like kind” (“Replacement Property”).
2. If rules are followed, a taxpayer can defer payment of tax on the gain realized from the sale of the Relinquished Property. Note that the gain is locked into the Replacement Property.

B. Same Taxpayer Rule.

1. Generally, the taxpayer entity that sold the Relinquished Property and deferred the gain from the sale must be the same taxpayer entity that purchases the Replacement Property.
2. Single-member LLCs are “disregarded entities” for tax purposes. As such, one single-member LLC can be used to sell the Relinquished Property and a different single-member LLC can be used to acquire the Replacement Property (so long as the sole member is the same in both LLCs).
3. In multi-member LLCs, an LLC that sold the Relinquished Property must acquire the Replacement Property.
4. This issue arises often in context of spouses wishing to do a 1031 Exchange. If one spouse owns the Relinquished Property as

separate property, that spouse should acquire the Replacement Property as his or her separate property. Similarly, if the Relinquished Property is owned by both spouses, then both spouses should acquire the Replacement Property. Any deviation from this risks a taxable event. Spouses wishing to avoid this issue should take remedial action prior to the sale of Relinquished Property.

C. Other 1031 Basics.

1. What are “assets held for productive use in trade or business”?
 - a. Cannot exchange personal residence or other personal assets.
 - b. Must consider the length of time the taxpayer held the Relinquished Property before the 1031 exchange and the length of time the taxpayer held the Replacement Property after the 1031 exchange (“Holding Period”). There is no bright-line rule for how long assets must be held. Two years is considered safe, two months would be considered risky.
2. What are “like-kind” assets?
 - a. Assets exchanged must be of a “like-kind” meaning you can swap real estate for real estate, but cannot swap real estate for equipment.
 - b. Also, cannot exchange an LLC membership interest for another LLC membership interest.
3. Types of Exchanges.
 - a. A simultaneous exchange between two parties, where the parties simultaneously swap assets.

- b. A deferred exchange, where the taxpayer sells the Relinquished Property and then later purchases the Replacement Property.
 - c. A reverse exchange, where the taxpayer purchases the Replacement Property and then later sells the Relinquished Property.
- D. Limited liability companies (“LLCs”) became the entity of choice for real estate investing.
 - 1. Widespread use began in the late 1980s, early 1990s as more and more states adopted statutes similar to the Delaware Limited Liability Company Act.
 - 2. LLCs combine asset protection and limitation on member’s personal liability with IRS-approved pass-thru tax treatment.
 - 3. Ease of formation and administration, in addition to pass-thru taxation and the limited liability protections, made LLCs popular for real estate investors.
 - 4. Investors often form new entities for each new property acquired.

II. THE 1031 DROP AND SWAP

- A. What happens when partners/members want to go in different directions?
Two problems:
 - 1. Internal Revenue Code subsection 1031(a)(2)(D) notes that partnership interests are not subject to 1031 transactions – that includes membership interests under LLCs.

2. Section 1031 requires that the entity/partnership that sold the Relinquished Property must be the same entity/partnership that acquires the Replacement Property – same taxpayer rule.
- B. Convert interests into a tenant-in-common arrangement. Deed property to each member in the same proportion as the members would have received from the distribution of sales proceeds.
 - C. Each tenant in common can decide what they want to do with their interest.
 - D. Simple in concept, but many obstacles and complications.

III. POTENTIAL RISKS AND OBSTACLES WITH DROP AND SWAP TRANSACTIONS

- A. IRS has reviewed Drop and Swap Transactions with greater scrutiny. 2008 form has added new questions in order to track drop and swaps. Form 1065, Schedule B, Item 14 asks partnership whether “at any time during the tax year, did the partnership distribute to any partner a tenancy-in-common or other undivided interest in partnership property.” This gives the IRS a convenient way to look at the “holding period” requirement for 1031 exchanges.
- B. “Held For” requirement – This is a timing issue. The Code requires that the property must be held for investment or for productive use in business or trade to be eligible for a 1031 exchange.
 1. There is considerable litigation arising out of a change in ownership of the Relinquished Property just before an exchange, or the Replacement Property just after an exchange.
 2. Code does not specify how long property must be held in order to be considered “being held for investment purposes.” IRS and Case Law is unclear on timing of holding period.

3. There is no carryover of the Holding Period of the partnership to the individual partners.
4. Can't turn partnership into a TIC and then immediately do a 1031 exchange.
5. Each new party must hold the property for investment purposes or productive use in business or trade.
 - a. Revenue Ruling 77-337 and Revenue Ruling 75-292 where short holding period was not permitted.
 - i. 75-292 involved a taxpayer who, immediately after the 1031 exchange, exchanged the replacement property to a corporation formed by the taxpayer. IRS determined that the taxpayer did not intend to hold the property for productive use in a trade, business or investment.
 - b. *Magneson v. Commissioner of Internal Revenue*; *Bolker v. Commissioner of Internal Revenue* where courts have allowed a 1031 transaction where an additional transfer occurred almost immediately before or after a transfer.
 - i. Magneson specifically distinguished Revenue Ruling 75-292 in part because *Magneson* considered a subsequent transfer to a partnership not a corporation as the Revenue Ruling.
 - ii. Magneson also pointed out that the Court of Appeals was not bound by Revenue Rulings.
6. Suggestions regarding how long TIC parties should hold property in order to satisfy this requirement.

- a. Wait until next tax year.
- b. 12 months.
- c. One year and a day rule.
- d. Bottom Line: Timing for establishment of tenancy in common. The tenancy in common arrangement should be established as early as possible, preferably before any specific negotiations begin with potential purchasers for the sale of the property. It is always better if the tenant in common arrangement is established in a different tax year than the sale of the property is made.

C. Deemed Continuation of Partnership.

- 1. IRS may re-cast co-ownership structure as a partnership in order to disallow 1031 deferred tax treatment.
- 2. Need to follow guidelines in Rev. Proc. 2002-22.
 - a. Ownership may be through an individual or a disregarded entity.
 - b. No more than 35 co-tenants.
 - c. TIC Agreement – a formal written agreement setting forth rights and obligations of the co-owners is permitted with the following limitations:
 - i. Cannot hold themselves out as partners, shareholders or members.
 - ii. Unanimous consent required to sell or lease under a TIC – unlike operating agreement.

- iii. However, each owner must have the right to transfer or encumber that co-owner's interest in the property except where a lender prohibits a transfer consistent with standard lending practice.
- d. Under a tenancy in common arrangement, profits interest members are not permitted, nor are any special allocations of cash flow or sales proceeds because of the essential proportionate ownership requirement in Revenue Procedure 2002-22. Capital accounts can become disproportionate for a variety of reasons during the existence of the partnership or LLC. However, a tenancy in common arrangement does not allow for the disproportionality and, therefore, this difference between the partnership interests or sharing ratios and owners' capital account balances will need to be resolved prior to the establishment of the tenancy in common interests.
- e. Section 761(a) election – election to have tenants in common not to be taxed as a partnership: Do this after transfer from LLC to TIC.
- f. May hire manager and/or brokers.
 - i. Must be renewed at least annually.
 - ii. Can maintain common bank account.
 - iii. Negotiate loans and obtain insurance.
- g. Property management should not be conducted by one party of the TIC arrangement. Should have an agreement in place with third-party company.

- h. Debt allocations. Debt secured by the property will need to be allocated to each member proportionately in accordance to their undivided interests in the property. Therefore, if only certain members guarantee the debt while the property is owned by a partnership or multiple-member LLC, they will lose their preferential recourse debt allocation to the extent a portion of the debt is reallocated to a non-guarantor co-owner.
 - i. Ownership of tenancy in common interests. It's recommended that each owner's undivided interest in the property be held through a single-member LLC, which is disregarded for federal income tax purposes. This will provide better legal liability protection for the co-owners.
 - j. Distribution of property to some partners. A tenancy in common can be created between the partnership and certain partners of the partnership by distributing undivided interests in the property to only certain partners (e.g., those who do not wish to engage in the like-kind exchange).
 - k. Change bank accounts and assign leases, if any, to TIC members.
- D. Step Transaction – IRS collapses the steps and treats it as a sale of a partnership interest. IRS, at times, has successfully argued that one should ignore the “drop” part of the drop and swap, then the transaction is an improper transfer of a partnership interest.

IV. OTHER FACTORS TO CONSIDER WHEN CONSIDERING A 1031 WITH A “DROP AND SWAP” COMPONENT

- A. Real Estate Transfer Taxes. A transfer from an LLC to its members may trigger real estate transfer taxes. A clear exemption is available for state

real estate transfer taxes (see MCL § 207.526(p) (i), (ii), or (iii)); however, no such clear exemption is available for count transfer taxes.

- B. Uncapping of Real Estate Taxes. With few exceptions, transfers from an LLC of an interest in real property to its members are not exempt from uncapping for real estate tax purposes.
- C. Environmental Issues. A transfer of an interest in the property from an LLC to its members will likely strip away any protections that the LLC had with respect to environmental issues at the property. For instance, if an LLC had done a baseline environmental assessment prior to purchasing the property, the protection afforded to the LLC would not necessarily carry over to its members in a “drop and swap” transaction, thus exposing the individuals to potential liability for environmental issues.
- D. Loan Covenants. Many loan documents contain “due on transfer” clauses which would be triggered by an LLC’s conveyance of a fractional interest to one of its members as is done in a traditional “drop and swap”. Loan documents should be consulted and, if necessary, a lender’s written consent should be obtained prior to transferring any interests in encumbered real property.
- E. Replacement Property Basis. A taxpayer’s basis in the Replacement Property will be the value of the Replacement Property, less the amount of gain deferred in the exchange (or plus the amount of unrecognized loss).
- F. Consequences of a Failed 1031 Exchange. If the IRS audits a transaction and finds that it does not qualify for tax-deferred treatment, the taxpayer will incur a significant tax liability related to the gain recognized on the sale of the Relinquished Property and will likely also incur penalties for substantial understatement of income and underpayment of tax.