

1031 Exchange

Drop & Swap

Holding title to real estate in an LLC or in a multi-member partnership may make sense when a property is originally acquired but can cause complications if the sellers would like to conduct a 1031 Exchange when the property is eventually sold.

In a 1031 Exchange, the taxpayer who sells real estate needs to be the same taxpayer to acquire replacement property. If XYZ, LLC sells real estate in an exchange, XYZ, LLC will need to purchase replacement property to complete the exchange.

Provided the members of the partnership intend to acquire property together, there is no issue. However, problems arise when the individuals within the LLC would like to part ways and exchange separately.

A possible solution would be to change the title of the property from the partnership to individual members with each member holding a fractional tenant in common (TIC) interest in the property. This 'drop' would then allow the individual members to sell and exchange (or swap) independently.

To properly drop and swap, the following steps should be taken at a minimum:

- Contact your tax advisor immediately.
- Fully liquidate the partnership as far in advance of closing as possible and before listing the property for sale.
- Distribute proportionate tenant in common (TIC) interests in the property to each of the individual members.
- Create a "tenancy in common agreement" that affirms how the property will be managed". Make it different than the original partnership agreement and make sure there is not a sharing of duties in exchange for higher profit.
- Assign all leases to the recently created tenant in common owners.
- Report income and expenses in proportion to TIC ownership percentages.

- Examine and follow the criteria set for in Revenue Procedure 2002-22.
- When selling the property, negotiate and enter in a sale agreement as individuals.

A Drop and Swap transaction works on paper and can be properly reported on tax returns. However, some jurisdictions have challenged Drop and Swap transactions under the substance over form theory that the partnership was the true substantive seller and not the recently created tenant in common individuals.

It is also important to note that federal partnership tax returns include two questions that can draw attention and increased risk to a drop and swap. Form 1065, Schedule B question 11, asks:

"...during the current or prior tax year, the partnership distributed any property received in a like-kind exchange or contributed such property to another entity (other than disregarded entities wholly-owned by the partnership throughout the tax year)"

Question 12, asks:

"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?"

The Drop and Swap solution is not guaranteed to be successful and investors attempting a Drop and Swap should discuss with their tax advisor.

Guidance for Tax Advisors

Tax advisors seeking additional information can reference:

1. Revenue Ruling 77-337, 1977 WL 43782 (1977); Revenue Ruling 75-292, 1975 WL 35378 (1975)
2. *Magneson v. Commissioner of Internal Revenue*, 753 F.2d 1490 (US TC 1985); *Bolker v. Commissioner of Internal Revenue*, 760 F.2d 1039 (1985); *Maloney v. C.I.R.*, 93. T.C. 89, Tax Ct. Rep. (CCH) 45863 (1989)
3. PLR 2005-21002 (February 24, 2005); PLR 2006-51030 (September 19, 2006)
4. *Chase v. Commissioner of Internal Revenue*, 92 T.C. 874 (1989)
5. California Franchise Tax Board Notice 2000 1107 02
6. *In re Matter of the Appeal of Giurbino, Taxpayer*, 2016 WL 10005734 (Cal. St. Bd. Eq.)
7. *In the Matter of the Appeal of Sharon Mitchell*, 2018 WL 10560573 (Ca. Off Tax App. 8/2/18)
8. *Appeal of Pau*, petition for rehearing denied, 2019-OTA-119; *Appeal of Pau* (December 17, 2017), Cal. St. Bd. of Equal., Case No. 959931

Contact Asset Exchange Company

Corporate Headquarters
1388 Sutter Street, #1212
San Francisco, CA 94109

Tel: 877-471-1031
info@ax1031.com
www.ax1031.com

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