1031 Exchange

Drop & Swap

Same Taxpayer Requirement

Holding title to real estate in an LLC or in a multimember partnership often makes sense when a property is acquired but can cause complications down the road at the time of sale.

In a 1031 Exchange, the taxpayer who sells relinquished property needs to be the same taxpayer who acquires replacement property. If XYZ, LLC sells relinquished property, XYZ, LLC will need to purchase replacement property to complete the exchange.

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

Solution – Drop and Swap

When exchanging separately, there is a simple solution known as “Drop and Swap”. Owners may change title of the exchange relinquished property from the partnership to individual members with each member holding a fractional tenant in common interest (TIC). This ‘drop’ would then allow the individual members to sell and exchange (or swap) independently. Individual members could also choose to pay taxes and not exchange.

Challenges & Steps to Take

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

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true substantive seller and not the recently created tenant in common individuals. The Drop and Swap solution is not guaranteed to be successful and investors attempting a Drop and Swap should discuss with their tax advisor.

When performing a drop and swap, the following minimum steps should be taken, when possible. This is a partial list and is not intended to be exhaustive of all steps.

- **Contact your tax advisor immediately.**
- **Fully liquidate the partnership** and record new deeds to the property as far in advance of closing as possible and preferably prior to listing the exchange property for sale.
- **Assign all leases** to the recently created tenant in common owners .
- **Report income and expenses** in proportion to TIC ownership percentages.
- **Create a TIC agreement** to replace the partnership agreement.

Important Update (Good News)

Traditionally, California auditors (FTB) have rejected exchanges involving Drop and Swap, particularly for "Drops" that occurred after the relinquished property was listed for sale. In January 2020, the California Office of Tax Appeals ruled against the FTB and in favor of a taxpayer who "Dropped" after the relinquished property was listed for sale. This is great news for California investors considering a Drop and Swap. Caution is still suggested and tax advisors should review the case **"In the Matter of the Appeal of Sharon Mitchell (OTA Case No. 18011715)"**

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