

1031 Exchange

FOCUS

SECTION 1031 OF THE INTERNAL REVENUE CODE IS ONE OF THE GREATEST WEALTH BUILDING TOOLS AVAILABLE TO INVESTORS



> Drop and Swap Issues

Internal Revenue Code Section 1031 allows investors to defer the payment of capital gains taxes when selling investment property.

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 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 simple 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' 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:

- Liquidate as far in advance of closing as possible.
- Execute and record a deed to transfer all partnership interests to the former partners as TIC.
- Execute an agreement to terminate the partnership and to terminate the partnership agreement. If there are any residual effects of the partnership after the drop, the IRS is more likely to deem it a partnership.
- Assign all leases to the former partners and direct lease payments to be made to each individual partner. Use separate bank accounts for the individual lease payments.
- Make sure the lease payments are in proportion to the TIC interest.
- Renegotiate the leases if necessary to make sure no former partners are providing any services. Use a separate property manager if possible.
- Each individual partner should pay property obligations such as property taxes separately and not from one account.
- Timely file a final partnership tax return and note that it is the final partnership return.
- Create a "tenancy in common agreement" that affirms how the property will be managed". Make it much different than the original partnership agreement and make sure there is not a sharing of duties in exchange for higher profit.

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Asset Exchange Company

Obviously, a ‘drop and swap’ takes careful planning and should be done well in advance of selling. The most common ways the IRS will attack a drop and swap is to challenge the “investment requirement” of the TIC owners based upon a short amount of time between the drop and the swap (Bolker Case, 9th Circuit).

They have also been known to challenge based upon the resulting TIC being deemed a partnership.

Recent Updates in California re: Drop & Swaps

In an important decision the California State Board of Equalization (“SBE”) voted unanimously in March 2015 that taxpayers did qualify for Section 1031 like-kind exchange treatment where those taxpayers first completed a Section 1031 exchange of real property, held their replacement real property as tenants-in-common, and then seven (7) months later transferred their tenants-in-common interests into a new limited liability company (“LLC”). This is sometimes known as a “swap and drop” transaction. The taxpayers’ prearranged plan and intent to later contribute their tenants-in-common interests into a new LLC did not deny those taxpayers Section 1031 tax-free exchange treatment. The SBE rejected the California Franchise Tax Board’s (“FTB”) assertions that a prearranged plan to contribute real estate to an LLC after an exchange should deny taxpayers tax-free exchange treatment. [This SBE decision is Appeals of Rago Development Corporation.]

This new SBE decision will not only affect “swap and drop” exchange transactions where real estate is later deposited into partnerships after an exchange, but this SBE decision could also apply to the “drop and swap” exchanges where real estate is first liquidated out of a partnership to the partners as tenants-in-common followed by the real estate being later exchanged tax-free under Section 1031.

The SBE is scheduled at their June 2015 meeting to decide whether a formal precedential opinion will be issued for this case, which will then be a binding precedent on both taxpayers and the FTB. Appeals of Rago Development Corporation provides taxpayers more certainty when utilizing partnerships and limited LLCs to do Section 1031 exchanges. The past aggressive FTB positions (where the FTB has regularly challenged both “drop and swap” and “swap and drop” Section 1031 exchanges) will now hopefully cease in the partnership and Section 1031 area for California taxpayers.

The subject matter in this newsletter is intended as general information only and not intended as tax or legal advice.

Please always consult your tax or legal advisor for any specific tax or legal matters.

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