1031 Exchange: Drop & Swap out of a Partnership or LLC

A Drop and Swap is a practice allowing a subset, or portion, of a partnership or LLC to engage in a 1031 exchange without the need for all parties to do a 1031 exchange.

Can a partner or member trade their share of a property interest upon sale?

One of the most common questions asked of a qualified intermediary involves the situation in which one or more members or partners in a limited liability company (LLC) or partnership wish to do a 1031 exchange and others simply wish to cash out. There are several practical difficulties in this regard starting with Section 1031 itself. The section generally provides

> "No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged for property of like kind which is held for productive use in trade or business or for investment".

However the section also provides for several exclusions to the ability to trade any qualified use asset and one of those exclusions states "This subsection shall not apply to any exchange of interests in a partnership." As a result, the challenge here is to allow members to go their separate ways while not deeming them attempting to trade in their capacities as members.

While there are multiple ways to structure transactions allowing various members to effectively trade their interest, by far the most common technique is for the outgoing member to have the LLC redeem the member's interest and to convey by deed the applicable percentage interest in the property equivalent to the member's former share. The transfer to the member and the subsequent trade by that person is generally referred to as a "drop and swap."

How is a 1031 drop and swap done?

A 1031 tax exchange drop and swap can take place in several different ways. As mentioned above, when the majority of members wish to cash out, the taxpayer can transfer his membership interest back to the LLC in consideration of his receipt of a deed for a percentage fee interest in the property equivalent to his former membership interest. The taxpayer would then own a tenant in common (TIC) interest in the relinquished property together with the LLC. At closing each would provide their deed to the buyer and the former member can direct his share of the net proceeds to a qualified intermediary.

At times, the majority of members will wish to complete an exchange and one or more minority members will wish to simply cash out. The drop and swap can be used in this instance also by dropping applicable percentages of the property to the exiting members while the limited liability company completes an exchange at the LLC level and the former members cash out and pay the taxes due.

Meeting the "Held For" Requirement in a Drop and Swap

As indicated above, in order for property to be exchanged, it must have been held by the taxpayer for use in a business or for investment. So, if on the eve of the closing on the sale of the relinquished property a fee interest is conveyed to the exiting member, that member would be hard pressed to claim that she personally had held the property for any real period of time. However, when outgoing members wish to

cash out, the “held for” requirement is less of an issue since the exchange is done at the LLC level and the LLC has clearly held the property for a qualified use for a significant length of time. It does not matter that the outgoing members will not have satisfied the holding period requirement since they are not seeking exchange status.

For quite some time there have been recommendations from different groups to the IRS to allow outgoing members to be able to tack on their holding period as members to their individually-held ownership interest prior to an exchange. The Joint Committee of Taxation, which every several years comes up with suggested tax-related recommendations, has stated:

> “For purposes of determining whether property satisfies the holding requirement under Section 1031 like kind exchange rules, a taxpayer’s holding period and use of property should include the holding period of and use of the property by the transferor, in the case of property….distributed by a partnership to a partner…”

To date the IRS has not adopted this position. If anything, over time the drop and swap appears to be increasingly disfavored by the IRS.

IRS Form 1065 U.S. Return of Partnership Income

In 2008, as part of the IRS’ attempt to limit drop and swap transactions, Schedule B 14 was added to Form 1065. Schedule B 14 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." Prior to the inclusion of this check-the-box requirement, drop and swaps were frequently done on a “don’t ask, don’t tell” basis.

As a result of this reporting requirement, it is far better, when planning on a member exchange, to distribute out to the member(s) in a tax year prior to the year in which the sale of the property takes place. This enhances the holding period requirement and separates the drop to a prior tax year from the year in which the former member is completing an exchange. Most Section 1031 experts also strongly suggest making any of these changes prior to entering into a contract for sale.

Underlying Loan Considerations

When a deed of conveyance to a fractional interest in the real estate is given to the outgoing member, that deed is subject to whatever debt is on the property, however the debt is an obligation of the LLC and not that of the member. As a result, the conveyance does not, by itself, act to transfer a pro-rata amount of debt to that member. In order to avoid all the debt remaining against the LLC, the Operating Agreement or the Partnership Agreement needs to be amended to allow for a special debt allocation to flow through to the member as part of his receiving a deed to the fractional interest.

Almost all loans secured by property contain “due on transfer” clauses. So conveying an interest in the property to one or more members may constitute a technical violation under the loan documents. This is often overlooked since the loan payments are kept current and the property would likely be sold before a lender took notice of any transfer.

Deemed Partnership

There is a long history of case law in which the IRS has successfully argued that if a TIC holding has the attributes of a partnership, the co-ownership relationship will be deemed a partnership. This would negate a drop and swap. Although there are many factors that go into determining whether a co-ownership constitutes a de facto partnership, the single largest factor is the degree in which the property is managed by the TICs. The least amount of management by the co-owners is helpful to avoid partnership characterization. Often in an attempt to deal with this consideration, the co-owners will appoint a single co-owner as management agent for the group or will have an outside management company manage the property.

For other various reasons, co-ownership groups will sometimes enter into a tenant in common agreement setting forth their respective rights and relationship. The terms of such an agreement comes from IRS guidance in the form of Rev. Proc. 2002-22. These agreements are often used by lawyers advising clients in order to rebut the argument of a deemed partnership. It is generally understood in the legal community that it is almost impossible for a co-ownership structure to adhere to each and every requirement set forth in the Rev. Proc., but many people try to pattern a tenant in common arrangement to include as many of the provisions as possible. Caution should be taken to avoid the situation where a TIC agreement is entered into, but its terms are ignored in whole or in part by the co-owners.

Summary

The possibility of structuring of a 1031 tax exchange by a subsection of the partners in a partnership or members in an LLC, is one of the most common questions asked by taxpayers to their exchange facilitator or their advisers. While at one time this was done regularly and with apparent impunity, over time the IRS has taken steps to limit this deferral opportunity when the taxpayer has failed to hold the property for an amount of time. The technique of “dropping” an interest to a partner in the form of a tenant in common ownership of title to the property and then “swapping” that interest is very popular. The same can be true when a member wishes to cash out where the LLC seeks to do an exchange. There are some planning steps that can be taken in order to provide the exchange transaction the best chance to pass IRS muster.