

1031 Exchange: When to “Drop & Swap” or “Swap & Drop”

We commonly hear a scenario as follows, members of a partnership or limited liability company (LLC) want to sell a property and part ways, they ask, "Can we do a 1031 exchange?" The answer is, "it depends." A core piece of the puzzle lies in the holding period of the property interest prior to the sale and exchange. For tax purposes a partnership and LLC are the same thing so we will reference an LLC below for simplicity.

It is very common for members of a limited liability company to sell a property and go their separate ways, some members may want to do a 1031 exchange, while other members may prefer to cash out. In these situations, either a “Drop and Swap” or a “Swap and Drop” may be able to be utilized.

In simple terms, a “Drop and Swap” is where the interest held in the LLC is dropped prior to the 1031 exchange. Using this technique members not interested in doing an exchange can be given a deeded interest to the property from the LLC while giving up their interest in the LLC. The remaining members can do an exchange under the LLC entity for the percentage interest in the real estate that is left with the LLC. In some situations, the LLC cannot be retained by any member and the “exchanging members” receive a deeded interest too. A “Swap and Drop” is where the 1031 exchange occurs at the LLC level with each member causing the LLC to acquire the property that the member would like to retain upon dissolution of the LLC. After a substantial holding period, generally two or more years, the LLC distributes each member’s interest to that member and the LLC is then dissolved.

When considering a “Drop and Swap”, the concerns are largely due to the fact that there is no clear test of what is an acceptable “drop and swap” 1031 exchange holding period. This is particularly relevant when circumstances do not allow the exchanging party(ies) to retain the LLC. When partners consider a drop from their partnership interest into a tenancy in common interest in the relinquished property and then swap or exchange out of the property, there is a danger if the “drop” takes place shortly before the sale closing, the IRS could disallow the exchanges into replacement properties. The IRS has reasoned that the tenancy in common interests in the relinquished property were not “held” long enough as investment or business use property, which is an essential requirement for the exchange. That is why, if possible, it is much better for those exchanging to retain the LLC ownership and it’s holding time. There are still some adventurous souls who engage in “Drop and Swap” transactions involving short holding periods after the redemption of the partnership interests in return for the deeded interests held as tenancy in common that are exchanged by those wishing to do an exchange. They have relied on a long line of taxpayer-friendly federal cases such as *Magneson v. Commissioner*, 753 F.2d 1490 (9th Cir. 1985).

A more conservative approach is a “Swap and Drop” in which the partnership proceeds with 1031 exchange which eliminates any concerns around the holding period. In a “Swap and Drop” the LLC sells the relinquished property and Real 1031, as the Qualified Intermediary, receives the exchange value per the 1031 Tax Deferred Exchange agreement. After the closing of the relinquished property, as referenced above, the partners identify replacement properties which may be different types, i.e., multi-family residential, commercial/warehouse or any other property that is investment or business use property. The partners then agree to a special allocation within the partnership to track the profits and losses for the properties and allocate them to the applicable member during the subsequent holding period. After the partnership has held the properties in that arrangement preferably for at least a couple of years, it will then distribute the property to the applicable member and each one continues with his/her personal ownership. While “Swap and Drops” are the more conservative approach, we rarely see them executed as “dropping” the interest on the backend requires LLC to stay intact for a period of time and a lot of things have to align in connection with the properties selected.

In summary, there is no clear test for the period of qualified use/holding period prior to a sale and exchange. It’s always important for anyone within a partnership or LCC that is contemplating a 1031 exchange with partners of diverging interests to talk to their tax advisors as soon as possible to avoid the pitfalls outlined above.