

Case Study: Drop & Swap Scenario in a Three-Person LLC

The Same Taxpayer Rule is a key requirement in 1031 Exchanges. The same individual or entity selling the Relinquished Property(ies) must also acquire the Replacement Property(ies) in order to qualify for tax deferral using a 1031 Exchange. Navigating this can become complex when a property is held in a multi-member limited liability company "LLC" and the property owners involved have different financial or investment goals. Ownership by a three member LLC is not the same taxpayer as ownership by the three members individually. In such cases, the "Drop & Swap" strategy can offer a practical solution. A Drop & Swap involves restructuring ownership, generally by transferring shared ownership into individual ownership before proceeding with a 1031 Exchange. This strategy allows co-owners to either proceed with a 1031 Exchange or cash-out, meeting various objectives within a shared investment. To put this strategy into practice, we'll examine a three-member LLC that owns an investment property, where each member has differing plans for the proceeds from the sale of the owned property.

The Facts

Three members of an LLC—Joe, Sarah, and Matt—co-own a commercial property in Denver. The property, initially purchased for \$2.5 million, is now valued at \$4 million, having appreciated significantly over the 10 years it has been owned by the LLC. The members of the LLC have decided to sell the property and utilize a 1031 Exchange to defer taxes and reinvest in like-kind property. While Matt intends to "swap" his share for like-kind property using a 1031 Exchange, Joe and Sarah want to "drop" their interest and cash out due to personal reasons, such as needing funds to pay for their children's college, wanting to invest in stocks using the funds, etc.

The Problem

Since two out of the three of the LLC members are "dropping," the decision is made to terminate the LLC in order to complete the transaction. Once the LLC dissolves, Joe and Sarah want to exit the transaction and receive their portion of the sale proceeds. The problem arises in how to appropriately structure the sale and distribution of the proceeds to allow each to proceed independently.

The Solution

Using professional advisers and a properly structured transaction, the property can be transferred with a single deed "dropped" from the LLC to the three individuals as Tenants-in-Common (TIC). Below are some of the general steps and considerations of the process in which the distribution and transfer of ownership could work:

- 1. LLC Termination:** The LLC will cease to exist upon conveyance of the property by deed to the members, and the property can then be sold by the three individuals. Since the LLC is now terminating, the ownership interests will be split among the three members, with each receiving a 1/3 interest in the property, with the value of approximately \$500,000 attributed to each, not taking into account closing costs or any debt payoff.
- 2. Sale of Property by the Tenants-in-Common:** Once the property becomes held by them in their own names, at the time of closing, they can act at closing independently from one another.
- 3. Alternative for Liability Protection:** Alternatively, for liability protection, Joe, Sarah, and Matt may choose to hold their ownership interests in the property through multiple single-member LLCs. This allows them to maintain limited liability protection while still benefiting from the transition to individual ownership.
- 4. Dropping and Swapping:** While Joe and Sarah "drop" from the exchange and face taxation on their gains, Matt is still able to continue with the 1031 Exchange by completing a swap into like-kind property using his 1/3 interest. The drop for Joe and Sarah means they will not reinvest and will incur tax, while Matt will proceed with his swap.

Holding Period Considerations for a Drop & Swap

When the LLC is dissolved, and the property is distributed to individual members, it's beneficial that anyone doing an exchange hold the property for some period of time before initiating the exchange.

If the drop (distribution) and swap (1031 Exchange) occur too close together, the IRS might question the transaction, at least in Matt's case, as he intends to complete a 1031 Exchange. IRS Code Section 1031 states:

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

There is no specific defined term for which the property must be held. Clearly in a drop & swap the property has been held for an extended period of time by the LLC, but not very long by the individual who is trying to execute the exchange. In general, the longer the period between the drop and the sale, the better it is to maximize the holding period.

However, there are scenarios where re-establishing a holding period may not be necessary. For example, another common scenario involving a Drop & Swap might occur if Joe and Matt both wanted to remain invested and complete a 1031 Exchange, while Sarah alone wanted to cash out. In this case, Sarah would receive a 1/3 Tenants-in-Common interest and 1/3 of the sale proceeds, resulting in a taxable event for her. Meanwhile, the multi-member LLC would remain intact, with Joe and Matt continuing as members to complete a 1031 Exchange using the remaining 2/3 of the proceeds.

By structuring the transaction this way, the LLC itself continues to satisfy the holding period requirements for the 1031 Exchange, avoiding the need to re-establish a fresh holding period. This approach can simplify the process for the remaining members, provided that the facts align, and the transaction is carefully structured.

To enhance the validity of the drop & swap, there are a few to keep in mind to plan ahead including the following:

- **Complete the Drop Before Contract Execution:** If possible, try and have the drop completed prior to the execution of the Relinquished Property disposition contract in order that it may be signed by the individuals rather than having it signed by the LLC and later assigned to the individuals.
- **Separate the Transactions by Tax Years:** Completing the drop in one tax year and the swap in a subsequent tax year helps separate the drop action from the IRS 1065 Partnership Return, particularly Schedule B 12, from the reporting by the individual of an exchange on IRS Form 8824.
- While holding the property for a sufficient period, it does not necessarily affect Joe and Sarah who are cashing out anyway, but it can be helpful to Matt to establish a new holding period and minimizing raising red flags and maximizes his 1031 Exchange qualifying under IRS guidelines.

In Summary

Joe and Sarah successfully "drop" out of the LLC, take their share of the sale proceeds, and pay taxes on their profits. Matt completes his 1031 Exchange and achieves tax deferral on his portion of the sale. While Joe and Sarah are no longer invested in the property and will pay taxes on their capital gains, Matt continues to expand his real estate portfolio.

In the end, Joe, Sarah, and Matt achieve their respective objectives: Joe and Sarah use their taxed funds to pay for their children's education and individual investment ventures, while Matt reinvests his share into like-kind investment property.

Drop & Swaps are complicated and involve many considerations and documentation not necessarily referenced here. As always, Exchangers are encouraged to consult with their tax and legal advisors before proceeding with the drop and swap as the sale of an investment or business-use property.