Structuring a Successful Drop-and-Swap

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In this article, Hubers argues that when co-owners hold property in a partnership, the drop-and-swap technique offers a viable means to facilitate a section 1031 exchange for some partners while allowing others to cash out of the investment and part ways.

Co-owners often hold real estate in a partnership to meet capital requirements or for other business reasons. But when an opportunity arises to exit the investment, the partners often disagree on the strategy. Some partners may prefer a liquidation event and are willing to pay tax to cash out of their investment, while others may wish to structure the transaction to qualify for a nonrecognition under section 1031 and avoid taxation until a future liquidation event. With advanced planning, the partners can structure a valid exchange that allows one or more partners to withdraw from the partnership and receive cash while permitting tax deferral for the exchanging partners.

I. Section 1031

Under section 1031(a)(1), no gain or loss is recognized on the exchange of real property held for a qualified use (relinquished property) if that property is exchanged solely for other real property of like-kind which is to be held for a qualified use (replacement property). By its terms, section 1031 only applies in the case of an exchange of real property. Although some intangible assets are considered real property if their value is derived and inseparable from an interest in real property, the regulations specifically state that an interest in a partnership is *not* considered real property, regardless of its classification under local law.[1] Accordingly, when partners want to end their relationship, a partner cannot merely exchange out of his partnership interest into replacement property and qualify for nonrecognition under section 1031. Instead, real property must be exchanged directly, either at the partnership level or the partner level.

A popular technique in pursuit of this goal is the drop-and-swap, whereby the partnership makes a liquidating distribution of undivided interests in the real property to the partners as cotenants. This type of distribution by the partnership is generally tax free under section 731. Later, the partners who are so inclined can separately effect section 1031 exchanges for their undivided interests when the whole property is sold. This transaction is not without tax risk; each party to the exchange must analyze the facts from its own perspective, accounting for all the issues outlined below.

II. Qualified Use

To qualify for nonrecognition treatment under section 1031, the taxpayer must hold both the relinquished property and the replacement property for either productive use in a trade or business or investment (qualified use). Property held for productive use in a trade or business may be exchanged for property held for investment and vice versa.[2] Courts have boiled down qualified use into a relatively simple inquiry: The taxpayer must lack the intent to (1) liquidate the investment or (2) use it for personal pursuits.[3] For example, in *Regals Realty*,[4] the Second Circuit

[1]Reg. section 1.1031(a)-3(a)(5).

[2]Reg. section 1.1031(a)-1(a)(1).

[3]*See Bolker v. Commissioner*, 760 F.2d 1039, 1044-1045 (9th Cir. 1985).

[4]*Regals Realty Co. v. Commissioner*, 127 F.2d 931, 933-934 (2d Cir. 1942).

found that the taxpayer's intent to sell the replacement property disqualified the exchange, and in *Click*,[5] the Tax Court found that the taxpayer's intent to give the replacement property away as a gift disqualified the exchange. This determination is based on the taxpayer's intent at the time the exchange is consummated. For example, in *Lindsley*,[6] the taxpayer expressed his intent before the exchange to donate the purported replacement property as a charitable contribution and did so shortly thereafter. The Tax Court thought it obvious that the taxpayer formed his donative intent before the exchange and, thus, section 1031 did not apply. The taxpayer bears the burden of proving the requisite intent.[7]

In a multistep transaction, it is crucial to examine how transactions before and after the exchange might affect whether the use remains qualified under section 1031. The drop-and-swap exchange is subject to challenge on account of the relinquished property because the partners receive it in liquidation of their partnership interests intending to exchange it for like-kind property. The IRS has historically been unwilling to attribute the partnership's qualified use to the partner post-liquidation. Accordingly, the IRS may advance the argument that the distributee partners did not hold the property for productive use in a trade or business or investment but instead held it for the sole purpose of exchanging it. In cases involving pre-exchange distributions from an entity, courts have generally ruled in favor of the taxpayer on the issue of qualified use based on the rationale that the taxpayer is continuing the investment in a different form. For example, in *Bolker*,[8] the Ninth Circuit considered whether property is held for qualified use when the taxpayer acquired it with the intent to exchange it for like-kind property. In that case, the taxpayer caused a corporation, of which he was the sole shareholder, to liquidate and distribute specified real estate to himself. In accordance with a prearranged plan, and on the same day, the taxpayer contracted to exchange the real estate for other like-kind property of a qualified use. The IRS argued, among other things, that the taxpayer never held the relinquished property for a qualified use because he acquired it with the intent, and almost immediate contractual obligation, to exchange it. The court rejected this argument because that position would require it to read an unexpressed additional requirement into section 1031 "that the taxpayer have, previous to forming the intent to exchange one piece of property for a second parcel, an intent to keep the first piece of property indefinitely." Instead, the court held that if a taxpayer owns the property, he is "holding" it; and if he lacks intent to liquidate the property or to use it for personal pursuits, he is holding it for a "qualified use." The drop-and-swap exchange has convenient similarities to the fact pattern of *Bolker*. After the liquidating distribution from the partnership, the distributee partners will own the relinquished property outright and thus "hold" it under the statute. Also, the distributee partners intend to exchange their interests in the relinquished property for qualified replacement property; they do not intend to liquidate it or use it for personal pursuits.

The Ninth Circuit based its holding in *Bolker* on its holding in *Magneson*, issued on the same day.[9] In *Magneson*, the court considered whether property is held for qualified use when the taxpayer acquired it in a like-kind exchange intending to contribute it to a partnership. In that case, the taxpayers exchanged a fee interest in wholly owned real estate for an undivided fee interest in other real estate. Under a prearranged plan, and on the same day, the taxpayers transferred their interests in the replacement property to a partnership formed with their cotenants to acquire, hold, and operate the property. The IRS argued that the taxpayer did not hold the property for a qualifying use because it was later contributed to a partnership. The court rejected this argument because the central purpose of both section 1031 and section 721 (providing tax-free treatment for contributions of property to partnerships) is to provide for nonrecognition on a transfer of property in which

[5] *Click v. Commissioner*, 78 T.C. 225, 233-234 (1982).

[6] *Lindsley v. Commissioner*, T.C. Memo. 1983-729.

[7] *Click*, 78 T.C. at 231; citing *Regals Realty Co.*, 127 F.2d 931.

[8] *Bolker*, 760 F.2d 1039.

[9] *Magneson v. Commissioner*, 753 F.2d 1490 (9th Cir. 1985).

the differences between the relinquished property and the replacement property "are more formal than substantial," and "the new property is substantially a continuation of the old investment still unliquidated." The court found that this principle exactly described the taxpayers' situation; the taxpayers owned income-producing real estate before and after the transaction, albeit in a different form of ownership. The court noted that the significant differences between holding property as a cotenant or as a partner lie in that property's voluntary or involuntary alienability; because the whole premise of section 1031 is that the taxpayer does not intend to alienate the property, those distinctions are not dispositive. Applying the court's reasoning in *Magneson*, the liquidating distribution associated with the drop-and-swap represents "substantially a continuation of the old investment still unliquidated" and should not interrupt the partners' qualified use holding period. The distributee partners own the relinquished property before and after the distributions, albeit in a different form.

There is also some favorable authority for this type of transaction in *Mason*.[10] In that case, the taxpayer and his partner owned interests in two separate partnerships holding real property. The parties split up the partnership assets under a sales contract, which provided that the taxpayer would convey to his partner all his personal and undivided interest in the real property owned by the first partnership, as well as some property owned by the second partnership. In exchange, the taxpayer received three properties from the second partnership and a note receivable from his partner. Specifically, the Tax Court characterized the exchange as a pro rata distribution of partnership assets under section 731 followed by a like-kind exchange of the real property interests under section 1031. This is precisely the tax treatment sought in a drop-and-swap exchange. While this case is helpful, neither the IRS nor the court reached the issue of whether the transfer constituted a *Magneson/Bolker*-type exchange and similarly failed to consider whether the property met the qualified use requirement.

[10] *Mason v. Commissioner*, T.C. Memo. 1988-273.

It is unclear whether the failure to raise qualified use in *Mason* represents a departure from the position taken by the IRS in *Magneson* and *Bolker* only three years earlier. It is just as likely that the omission was simply an oversight. In a field service advice memorandum from 1999, the IRS stated that while "we disagree with the conclusion that a taxpayer that receives property subject to a prearranged agreement to immediately transfer the property holds the property for investment, we are no longer pursuing this position in litigation in view of the negative precedent" (noting that the position had been rejected on several occasions and citing *Magneson* and *Bolker*).[11] Similarly, an attorney from the IRS National Office indicated at an American Bar Association Section of Taxation meeting in May 2012 that he would not be inclined to litigate *Magneson* issues.[12] On the other hand, the IRS added two questions to Form 1065, "U.S. Return of Partnership Income" in 2008 that elicit information on whether the partnership distributed any (1) undivided interests in partnership property or (2) property received in a like-kind exchange. The inclusion and retention of these questions indicate that the IRS is at least tracking drop-and-swap exchanges.

III. Identity of Ownership

For section 1031 to apply, the "taxpayer" must effect the exchange; that is, the same taxpayer must be both the transferor and the transferee in the transaction. For example, if a partnership relinquishes the exchanged property, that same partnership must also acquire the replacement property. In a drop-and-swap exchange, there is a risk that the exchange will be attributed to either the distributing partnership or a de facto partnership imputed on the cotenants of the relinquished property. If the court deems the partnership to be the true transferor of the relinquished property on this theory, a subsequent purchase of replacement property by individual partners will not qualify as a like-kind exchange under section 1031.

[11] FSA 199951004.

[12] Howard J. Levine, "Significant Developments in Like-Kind Exchanges," 56 Tax Mgmt. Memo. No. 6 (Mar. 23, 2015).

A. Partnership as Exchanging Party

In *Court Holding*,[13] the Supreme Court applied the substance-over-form doctrine to find that a corporation, not the shareholders, sold the property at issue because the shareholders were merely a "conduit through which to pass title." One of the taxpayers negotiated the sale of corporate property on behalf of the corporation. After discovering that the sale would result in the imposition of significant income taxes, the taxpayers immediately caused the corporation to distribute the property to them, in kind, as a liquidating dividend and then sold the property to the purchaser under the same terms negotiated on behalf of the corporation. The Court found that the liquidation dividend was a mere formalism, and the true nature of the transaction was a sale by the corporation. Five years later, in *Cumberland*,[14] the Supreme Court distinguished its opinion in *Court Holding*, respecting the form of a transaction as a sale of property by the shareholders following a liquidating distribution by the corporation. Although the taxpayer avowedly chose to dispose of the property by this method to reduce taxes, the liquidating distribution was genuine, and the corporation never intended to make the sale itself. The Court clarified that its opinion in *Court Holding* did not mean that the substance-over-form doctrine could be invoked to attribute a sale of property by shareholders to the corporation following a *genuine* liquidation. The Court later noted in *Central Tablet* that "these two cases obviously created a situation where the tax consequences were dependent upon the resolution of . . . whether the negotiations leading to the sale had been conducted by the corporation or by the shareholders."[15]

After *Court Holding* and *Cumberland* were decided, the courts attempted to create a workable test to define the level and nature of organizational involvement that must be present before a sale or exchange might be imputed to that entity. In *Merkra*, the Tax Court stated that a "sale cannot be attributed to the corporation unless the corporation has, while still the owner of the property, carried on negotiations looking toward a sale of the property, and in most cases the negotiations must have culminated in some sort of sales agreement or understanding so it can be said the later transfer by the stockholders was actually pursuant to the earlier bargain struck by the corporation — and the dissolution and distribution in kind was merely a device employed to carry out the corporation's agreement or understanding."[16] Similarly, in *Hines*, the Fifth Circuit stated that "the *sine qua non* of the imputed income rule is a finding that the corporation actively participated in the transaction that produced the income to be imputed. Only if the corporation in fact participated in the sale transaction, by negotiation, prior agreement, post distribution activities, or participated in any other significant manner, could the corporation be charged with earning the income sought to be taxed. Any other result would unfairly charge the corporation with tax liability for a transaction in which it had no involvement or control."[17]

The principles of this line of cases were applied in the context of a purported section 1031 exchange by former partners in *Chase*.[18] In that case, the Tax Court found that the partnership was, in substance, the true transferor of the real estate even though the taxpayers were, in form, co-transferors. Accordingly, the exchange did not qualify under section 1031 because the partnership transferred the relinquished property, and the individual partners acquired the replacement property. The partnership received an offer to purchase real estate from an unrelated individual. After the partnership accepted the first offer, but before the scheduled closing date, the taxpayers caused the partnership to deed an undivided interest in the real estate to them in liquidation of their partnership interests. The taxpayers attempted to structure the subsequent sale of the real estate as a section 1031 exchange with respect to themselves. In applying

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13 *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945).

14 *United States v. Cumberland Public Service Co.*, 338 U.S. 451 (1950).

15 *Central Tablet Manufacturing Co. v. United States*, 417 U.S. 673, 680 (1974).

16 *Merkra Holding Co. v. Commissioner*, 27 T.C. 82, 92 (1956).

17 *Hines v. United States*, 477 F.2d 1063, 1069-1070 (5th Cir. 1973).

18 *Chase v. Commissioner*, 92 T.C. 874 (1989).

the substance-over-form doctrine, the Court noted that the deed to the taxpayers was a superficial formality that did not vary, control, or change the flow of economic benefits because the taxpayers did not record the deed until they were certain that the deal was going to close, the taxpayers did not pay any portion of the commission to the real estate broker, the taxpayers did not pay any of the operating expenses of the real estate between the date of the deed and the date of sale, the taxpayers did not receive a share of the rents between the date of the deed and the date of the sale, and one of the taxpayers signed the escrow agreement on behalf of the partnership and not on behalf of the taxpayers in their individual capacities as owners of the real estate. The fact pattern in *Chase* was analogous to the fact pattern in *Court Holding* because the partnership negotiated the exchange, and the distribution was merely a device employed to carry out the agreement previously negotiated by the partnership. In contrast, the trial court in *Bolker*[19] rejected the IRS's argument that the corporation, not the taxpayer, had in substance disposed of the property in a purported section 1031 exchange by the former sole shareholder of the corporation. The court found that the fact pattern fit the mold of *Cumberland* rather than *Court Holding* because (1) the taxpayer had negotiated the exchange in his individual capacity, and (2) there was minimal corporate involvement in the negotiations.

In most drop-and-swap exchanges, the analysis is muddied by the fact that the distributee partners are the same persons who would otherwise be negotiating on behalf of the partnership. The Court acknowledged this reality in *Cumberland*, noting that the distinction between a sale by the entity, as compared with a distribution in kind followed by a sale by the distributee, is "particularly shadowy and artificial" in the context of a closely held business. The *Bolker* court wrangled with this issue as well. In that case, the buyer testified that it was unnecessary to distinguish between the taxpayer and the corporation during negotiations because the taxpayer was the sole shareholder. But the court found it dispositive that the taxpayer insisted on making the exchange personally and that voluminous documentation involving the deal referred to the taxpayer as the seller in his individual capacity. Accordingly, as long as the deal's formalities, in all respects, refer to the distributee partners as the transferors, the court will likely respect form. Still, there is a risk that a court could find the partnership to be the true party to the exchange and disqualify the transaction from section 1031 on that theory.

[19]*Bolker v. Commissioner*, 81 T.C. 782 (1983).

B. Imputed (De Facto) Partnership

There is also a risk that the courts may impute a de facto partnership when one is not otherwise recognized by the purported partners if their cotenancy satisfies the definition of a partnership under section 761(a). But even if the court can successfully impute a continuing partnership on former partners, that alone does not make the relinquished property "partnership property." In *Magneson*, the Court found that state law controls in determining the nature of the taxpayer's legal interest in the property at issue.[20] In most states, property acquired in the name of one or more of the partners, without an indication in the instrument transferring title to the property of the person's capacity as a partner or of the existence of a partnership and without the use of partnership assets, is presumed to be separate property, even if used for partnership purposes.[21] If partnership property is deeded to the partners in their individual capacity, that property is presumed to be separate property. Accordingly, the conveyance itself would likely be sufficient evidence to rebut any argument to the contrary. As an example, in *Wagensen*,[22] the taxpayer held both the relinquished real estate and the replacement real estate for use in a ranching partnership of the taxpayer and his son; while there would have been identity of ownership in any event, all parties to the litigation treated the property as the taxpayer's separate property.[23]

[20]*Magneson*, 753 F.2d at 1495.

[21]*E.g.*, Fla. Stat. section 620.8204(4).

[22]*Wagensen v. Commissioner*, 74 T.C. 653 (1980).

[23]*Id.* at 658.

Also, some relief may be offered by section 1031(e), which provides that an interest in a partnership that validly elects under section 761(a) to be excluded from the application of subchapter K shall be treated as an interest in each of the partnership assets and not as an interest in the partnership. But that election is unavailable when the purported partners are actively conducting a business.[24] To curb the risk of the imputation of a partnership, the distributee partners should cease carrying on any trades or businesses associated with the relinquished property so that their holding of that property is for investment purposes only. The distributee partners can accomplish this by interposing a third party to carry on any activities that a court might construe as trades or businesses, with the partners receiving the financial return under a triple net lease. Then an election under section 761(a) to be excluded from partnership treatment should be valid and protect them from this challenge.

IV. Exchange of a Partnership Interest

As noted earlier, interests in partnerships are not considered real property under section 1031 regardless of whether they hold real property or are regarded as real property under local law.[25] Accordingly, the taxpayers must exercise caution to ensure that no judicial doctrine recasts the transaction as an exchange of a partnership interest rather than real property. When a partnership makes a liquidating distribution of real property to a partner and that partner later exchanges that property in a purported section 1031 exchange, there is a risk that the court will apply either the substance-over-form doctrine or the corollary step transaction doctrine to treat the transaction as an exchange of the partnership interest itself for the replacement property. Under the substance-over-form doctrine, the substance rather than the form of a transaction determines its tax consequences, particularly if the form is merely a convenient device for indirectly accomplishing what could have been achieved by selecting a more straightforward route. Under the step transaction doctrine, the tax consequences of an interrelated series of transactions are not determined by viewing them each in isolation but by considering them together as components of an overall plan. Successful application of the doctrines requires a showing that the character of the transaction is in every respect (other than the superficial and irrelevant one of form) a sale, resulting in precisely those consequences that would have occurred if the taxpayer simply had exchanged the partnership interest for the replacement property.[26]

For example, in *Crenshaw*, the taxpayer was a partner of a partnership that owned a parcel of real estate.[27] The taxpayer's business partner offered to buy the taxpayer out of the partnership for cash; however, the taxpayer's attorney suggested that a like-kind exchange would be a more appropriate course of action. Accordingly, the taxpayer engaged in the following series of transactions: (1) the taxpayer withdrew from the partnership in exchange for an undivided interest in the underlying real property (the relinquished property); (2) the taxpayer exchanged the relinquished property for other like-kind real estate owned by her husband's estate (the replacement property); (3) the taxpayer (as executrix) caused her husband's estate to sell the relinquished property for cash to an entity owned by the business partner; and (4) the entity owned by the business partner transferred the relinquished property back to the partnership in exchange for the partnership interest formerly owned by the taxpayer. The court stepped the transactions together, finding the collapsed series of transactions to be, in substance, a sale of the partnership interest to the entity for cash, followed by a purchase of the replacement property from the estate with the cash. Crucial to the holding is the fact that the parties were identically situated after the series of transactions to the situation that would have resulted from the direct route: an exchange of the partnership interest. Specifically, the entity owned the partnership interest formerly owned by the taxpayer, the partnership still owned all the

[24] Section 761(a)(1).

[25] *See* reg. section 1.1031(a)-3(a)(5).

[26] *Crenshaw v. United States*, 450 F.2d 472, 475 (5th Cir. 1971).

[27] *Id.* at 472.

relinquished property, the taxpayer owned the property formerly owned by the estate, and the estate had cash. The court noted that unless the final step was consummated, the transaction would not have been equivalent to a sale, and the doctrine would not have applied because the partnership interest would have been "liquidated" in a true sense. The transaction could only be recast as a sale of the partnership interest because the partnership interest survived.

In a drop-and-swap exchange from a general partnership, the end result is arguably the same as if the buyer had purchased the partnership interests from each partner. If the buyer had done so, the general partnership would have dissolved as a matter of law, and the buyer would own the property outright. But most drop-and-swap exchanges will involve a distribution from a legal entity, such as a limited liability company. In this case, the end result is significantly different than if the buyer had purchased the LLC interests because, after the transaction, the buyer owns the property outright instead of inside the LLC. This defeats the application of these doctrines as outlined in *Crenshaw* because the legal entity either does not survive or is carried on by the partners without the relinquished property.

In *Magneson*, the IRS argued that the step transaction doctrine should be applied to treat the transaction as an exchange of real estate for a partnership interest because the taxpayer transferred the replacement real estate to a partnership under a prearranged plan.[28] The Court refused to apply the doctrine because there was no more direct route to carry out the transaction. Similarly, in a drop-and-swap exchange from a legal entity, there is no more direct route to carry out the transaction to the intended result. The only other way to carry out the transaction would require the same number of steps but in a different order: a sale of the partnership interests followed by a distribution to the buyer.

In *Mason*, the Tax Court respected the form of the transaction in which the taxpayer and his business partner effected a pro rata distribution of partnership assets in liquidation of the partnership followed by a like-kind exchange.[29] The IRS argued that the parties, in substance, contemplated an exchange of partnership interests. The court rejected this argument, finding that the parties intended to exchange their interests in real property held individually and not their interests in the partnerships. In so finding, the court noted that the sales contract provided that the taxpayer and his business partner agreed to "exchange between themselves certain tracts of real property"; repeatedly referred to personal, not partnership, conveyances of property; and contemplated exchanges of assets held individually rather than by the partnerships. The fact pattern in *Mason* is strikingly similar to a drop-and-swap exchange. While the *Mason* holding may not be that useful from a "qualified use" perspective (because the IRS didn't raise that issue), the case is directly on point for the proposition that an exchange of real property in an individual capacity following a section 731 liquidating distribution should not be treated as an exchange of partnership interests so long as the transaction was negotiated and entered into by the taxpayers in their individual capacities.

V. Conclusion

The drop-and-swap technique offers a viable means to facilitate a section 1031 exchange for some partners while allowing others to part ways with cash. The IRS has, thus far, been unsuccessful in challenging this technique on its merits but has had marked success targeting taxpayers who are too cavalier with the formalities of their deals. Accordingly, taxpayers must tread lightly and plan carefully to avoid the pitfalls discussed in this article. ■

[28] *Magneson*, 753 F.2d at 1497.

[29] *Mason*, T.C. Memo. 1988-273.