DROP AND SWAP: CAN YOU RELAX IF THE POLICE AREN'T LOOKING FOR YOU?

By David R. Chan [1]

I. INTRODUCTION

One of the most common real estate transactions in recent years involves a partnership, which has held operating or investment real estate held for many years, that distributes undivided tenant in common interests in the property to its partners. Those partners then dispose of their undivided interests either by §1031 like-kind exchange for replacement real property or cash sale in a taxable transaction as they please. This transaction is so commonplace that it has its own short hand nickname—the drop and swap transaction.[2]

The drop and swap transaction is an easy solution to a common scenario where a partnership holds a real estate investment that has appreciated over a long period of time, and the partners disagree over whether to exchange the old property into a new one or sell the property for cash and recognize the gain. There are numerous other potential solutions to this problem, but most of them suffer from practical problems. The partnership could fully replace its investment after making liquidating cash distributions to partners who do not wish to participate, but finding the cash and sufficient time to arrange such a transaction is often a major obstacle. The partnership could do a partial §1031 replacement transaction, taking back cash boot equal to the cash required to liquidate the partners who do not wish to participate in the replacement property, with a distribution of the cash and a special allocation of the recognized gain to the outgoing partners. However, quite often this does not work because the allocation of the gain to the outgoing partners fails the § 704(b) requirement that partnership allocations have substantial economic effect, as the outgoing partners may not receive a full distribution of their tax capital accounts. This particular infirmity may be remedied by the partnership taking back an installment note for the boot portion of the exchange and subsequently distributing this note, rather than cash, to the outgoing partners. However this latter transaction appears to be too complicated for most partnerships to understand, and hence is not often seen in actual practice.

It is against this backdrop that the drop and swap transaction has become the vehicle of choice in cashing out partners who do not wish to continue in the partnership's new property. It is fast and easy to understand and is seemingly transacted around the

---

[1] David Chan, a principal with Ernst & Young, has more than 33 years experience in real estate law. He is widely published in real estate periodicals. David received a BA in Economics, an MS in Business Administration, and a JD from UCLA. He is a member of the Southern California Chinese Lawyers Association, the AICPA, the California Society of Certified Public Accountants, and the Asian Business League. As an Executive Director at Ernst & Young, he is a leader of the Tax Quality and Risk Management group.

[2] The views expressed in this article are those of the author and do not necessarily reflect the views of Ernst & Young LLP.

clock, seven days a week. Thousands of partnerships and partners can give testimonials as to how the drop and swap solved all of their problems. And indeed, there seems to be no anecdotal information that the IRS has challenged any drop and swap transactions in recent years in audits of taxpayers.

But as taxpayers happily engage in drop and swap transactions on a daily basis, more than one tax advisor has given pause to the technical merits of such a transaction if there were to be an attack by the government. Certainly there does not seem to be an issue as to whether there is sufficient authority to permit a tax preparer to report a drop and swap transaction as a valid §1031 exchange. However in those situations where the measurement standard is higher, such as for certain financial statement purposes and the ill fated and since repealed 2007 §6694 tax preparer penalty standard, where a tax position is measured by a *more likely than not* standard, there are major issues whether the higher standard may be satisfied.

Indeed, there are at least three counts on which the drop and swap transaction could be subject to a potential governmental attack--the "holding" requirement of §1031, the § 1031 prohibition on like-kind exchanges of partnership interests, and the historic *Court Holding* company doctrine.

II. HOLDING REQUIREMENT

Section 1031 provides that no gain or loss is recognized where property held for productive use in a trade or business or for investment is exchanged for other property which is also held for productive use in a trade or business or for investment. This "held for" or "holding" requirement is one of intent measured at the time of the exchange. In looking at this language, it might appear that any business property constituting § 1231 property or § 1221 investment property could qualify for § 1031 exchange treatment, since it is seemingly held for investment or productive use in a trade or business and does not fall into one of the § 1031(a)(2) exclusions.

However, even though a property would otherwise qualify for treatment as a capital asset held for investment or § 1231 property, it might not constitute qualified use property entitled to § 1031 like-kind treatment if the holding of either the exchange property or the replacement property is transitory, i.e., there is an intent to subsequently dispose of the property, even in a nontaxable transaction. Under the holding requirement, it could be argued that the partner did not hold the property in question for productive use in a trade or business, but rather held it for the purpose of making a disposition, either a subsequent § 1031 exchange in the case of recently acquired property, or a transfer to another entity or person in the case of property received in a § 1031 exchange. See for example *Dollie H. Click,*[3] where the taxpayer traded investment property for two residential properties which could have constituted investment property. However the replacement properties were gifted seven months later to the taxpayer's children for use as personal residences. The Tax Court held that the exchange of the residential property for the two replacement properties did not qualify under § 1031 since the taxpayer had no

[3] *Dollie H. Click*, 78 TC 225 (1982)

intent to hold the replacement properties for investment. See also *Fred S. Wagenson,*[4] a similar case involving the gift of the replacement property nine months after the exchange, where the taxpayer's § 1031 transaction was upheld because the taxpayer did not intend to make the gift at the time that the replacement property was received.

While *Click* and *Wagenson* involved §1031 issues dealing with the holding requirement as applied to the replacement property received in the exchange, the holding requirement applies equally to a property which is held momentarily, then disposed of in a purported §1031 exchange. In Rev. Rul. 77-297[5], a taxpayer purchased property and immediately exchanged it for seemingly like-kind property. The IRS held that the taxpayer's exchange did not qualify under § 1031 because the relinquished property did not meet the holding requirement.

However, the holding requirement is not as black and white as the preceding authorities may suggest. As indicated by the companion cases of *Bolker v. Commissioner,*[6] and *Magneson v. Commissioner,*[7] the holding requirement is not so readily applied to transitorily held property in the context of transfers of property in or out of business entities (See also *Bonny B. Maloney* [8]). These cases upheld the § 1031 treatment of transactions involving both the immediate exchange of recently received property as well as the immediate disposition of replacement property received in an apparent § 1031 exchange. When these cases were first decided, many commentators cautioned that these cases might be limited by the particularly pro-taxpayer factual circumstances that they contained. Furthermore, these cases predated the enactment of §1031(a)(2)(D) noted below, as well as potentially key changes in state law. Some commentators continue to follow this cautionary path, though given the amount of time that has passed since these cases have been decided without further clarification; perhaps the particular facts of those cases are no longer as important. In any event the cases certainly provide substantial authority for the position that the holding requirement does not of itself disqualify drop and swap transactions from §1031 treatment.

III. PROHIBITED EXCHANGES INVOLVING PARTNERSHIP INTERESTS

Section 1031(a)(2) disqualifies from §1031 treatment various classes of property including inventory property, partnership interests, and stocks and securities. In the transaction where the partnership distributes out undivided interests in its property and some of the partners attempt a §1031 exchange of their undivided interests, there is a very real danger that the transaction may be characterized an exchange by the partner of a partnership interest under §1031(a)(2)(D).

At first blush, the application of § 1031(a)(2)(D) to this transaction may appear far fetched because the partner clearly exchanged an undivided interest in real property,

---

[4] *Fred S. Wagenson*, 74 TC 653 (1980)
[5] Rev. Rul. 77-297, 1977-2 CB 304, IRC Sec(s). 1031
[6] *Bolker v. Commissioner*, 760 F.2d 1039 (9th Cir., 1985)
[7] *Magneson v. Commissioner*, 752 F.2d 1490 (9th Cir. 1985),
[8] *Bonny B. Maloney*, 93 TC 89 (1989)

not an interest in the former partnership, for the replacement real property received. Undivided interests in real property clearly qualify for § 1031 treatment. See Rev. Rul. 73-476.[9] The problem is that under the Internal Revenue Code, the term "partnership" is not limited to legal entities which operate in partnership form under state law. Rather, the tax law has its own definition of partnership which extends well beyond legal entities. Under § 761, the term "partnership" is defined to include a syndicate, group, pool, joint venture, or other unincorporated organization through or by which any business, financial operation or venture is carried on. Regulations go on to further expand on the statutory definition. In Reg. § 301.7701-1(a)(2) it is stated that "tenants in common, however, may be partners if they actively carry on a trade, business, financial operation, or venture and divide the profits thereof." For example, a partnership exists if co-owners of an apartment building rent space and in addition provide services to the occupants either directly or through an agent. Under this definition, the fact that the partnership distributes out undivided interests in its property to its partners may arguably be a meaningless act, as the subsequent co-ownership of the property by the former partners may very well be treated as a partnership under § 761, notwithstanding the elimination of the partnership as a legal entity.

While this language in the § 7701 regulations seemingly implies that any co-owned operating real property could constitute a partnership, this language is countered in part by subsequent language in the same regulation which states that mere co-ownership of property which is maintained, kept in repair and rented does not constitute a partnership. Taken in conjunction with the language noted in the § 7701 regulations, it seems that the co-ownership of property does not constitute a partnership so long as a certain level of services is not rendered to the tenants of the property. Admittedly, the amount of services which may be provided to the tenant is probably quite low, and may very well be too low for any category of operating real property rental aside from net lease property to escape partnership treatment. However, without any further clarification beyond that in the regulations, tax advisers might optimistically read the exclusion from the definition of a partnership under § 761 quite broadly, to avoid the conclusion that a § 1031 drop and swap exchange involves a partnership interest.

The government had the opportunity to clearly address the issue in the course of issuing guidance on § 1031 like-kind exchanges involving small fractional interests in relatively large pieces of real property. As real estate values began to escalate in the late 1990s, many taxpayers wanted to dispose of longstanding real estate investments but did not want to pay the (relatively modest) capital gains taxes that would be owing, nor continue to have the burdens of owning an operating property. This gave birth to an entire new industry involving the procurement of large properties, in the beginning typically credit tenant net lease properties, and dividing the properties into small fractional interests which could be sold off the shelf to taxpayers needing to quickly find replacement property for a § 1031 exchange. This was particularly attractive to taxpayers looking to complete a § 1031 exchange with property which more resembled a financial instrument than an ownership interest in real property. This industry became known as

[9] Rev. Rul. 73-476, 1973-2 CB 300, IRC Sec(s). 1031

the TIC industry after the tenant-in-common (TIC) interests that it created in acquired properties.

Despite the risks that such TIC interests might be characterized as a partnership interest ineligible for treatment as exchange property or replacement property in a § 1031 exchange, enough taxpayers, mostly in the Los Angeles area, took a flyer and began to use these marketed TIC interests as replacement property. This practice became prevalent enough to attract the attention of the government, resulting in the issuance of Rev. Proc. 2002-22.[10] This procedure essentially created a 15 point safe harbor under which a TIC interest would not be treated as an interest in a partnership. However, given that the procedure is only a safe harbor and not a declaration of substantive rules, and the specific points are most relevant to marketed TIC interests involving relatively small fractional interests, it is not nearly as helpful as it could have been in resolving the issue of whether the former partners in the partnership owning distributed tenant in common interests continue to own interests in a successor deemed partnership. However Rev. Proc. 2002-22 does state that providing customary services to tenants such as utilities, unattended parking, normal repairs and trash removal does not constitute business activity that would create a partnership, citing Rev. Rul. 75-374.[11] There is some significance in the reference to Rev. Rul. 75-374, since many observers had considered that ruling to be of limited and narrow application due to the fact that one of the co-owners was a real estate investment trust (REIT) which had been at that time subject to some rather restrictive requirements to maintain their REIT status. Consequently, Rev. Rul. 75-374 could well provide substantial authority to conclude the co-tenancy in our example is not a partnership. Nevertheless, tenant-in-common interests involving properties having a long time history as partnership operations remains a murky topic.

IV. *COURT HOLDING* DOCTRINE

Perhaps the most problematical issue with a drop and swap transaction is the possible application of the *Court Holding* doctrine to the exchange transaction where the distributed property is immediately disposed of in an apparent § 1031 exchange. The effect of the application of the doctrine would be to treat the exchange as being consummated at the partnership level, resulting in the recognition of income at the partnership level, such that the gain recognized would be allocable proportionately to all the partners, rather than just to the cashed out partners.

The *Court Holding* doctrine refers to the dichotomy between the *Court Holding* and *Cumberland Public Service* U. S. Supreme Court cases dealing with the question of whether a distribution of property to a shareholder by a corporation followed by a disposition of that property by the shareholder would be recast as disposition of the property by the corporation. In *Commissioner v. Court Holding Co.*,[12] the Court held that a liquidating corporation could not escape taxation on the gain realized from the sale of its sole asset if the corporation itself had arranged the sale prior to liquidation and

[10] Rev. Proc. 2002-22, 2002-1 CB 733, 03/19/2002, IRC Sec(s). 1031
[11] Rev. Rul. 75-374, 1975-2 CB 261, IRC Sec(s). 761
[12] *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945)

distribution of the asset to the shareholders. This was so even though the sale was consummated after the distribution. (Under the *General Utilities* doctrine in force at the time, if there were truly a liquidating distribution of property to the shareholders, it would have been nontaxable to the corporation.) In the typical drop and swap transaction, the drop of the partnership property into the hands of the partners is followed by the ultimate exchange by mere minutes, if not seconds. This makes a *Court Holding* type of contention that any § 1031 exchange was really consummated at the partnership level a very plausible one.

Of course, *Court Holding* cannot be discussed without also mentioning the case of *United States v. Cumberland Public Service Co*.,[13] where the Court reached exactly the opposite conclusion in the same type of transaction, but where the shareholders, rather than the corporation, had negotiated the sale of the distributed assets and, prior to the corporation's liquidation, had been in touch with the purchaser and had offered to acquire the property and sell it to the purchaser. The distinction between the two cases is strictly factual and indeed Justice Black, who wrote for a unanimous court in both cases, recognized that in a closely held situation, the distinction as to who made the sale was "particularly shadowy and artificial."

Obviously, the $64 million question is where does *Court Holding* stop and *Cumberland Public Service* begin, and just as obviously there is no precise, objective answer to this question. However, it would seem that if the distribution and exchange are simultaneous, a purported § 1031 exchange by one of the former partners could easily fall on the bad side of the *Court Holding* determination. See PLR 9645005, where a partnership had negotiated the sale of condemned property, but on the day before the closing of the transaction, undivided interests in the property were distributed by the partnership to its partners, who transferred their undivided interests to the purchaser under the contract. The IRS ruled that the partnership, not the partners, was deemed to be the selling party.

It would seem that some kind of new and imaginative argument would be needed for drop and swap transactions to avoid a *Court Holding* type of result. Perhaps, for example, *Court Holding* arguably doesn't apply to a partnership to the extent the aggregate theory of partnerships is applied to a drop and swap transaction. Partnerships are treated for some tax law purposes as an aggregate of its various parties (i.e., the aggregate theory of partnerships) for some purposes and as a separate tax entity for others (i.e., the entity theory of partnerships), with no general rule governing which applies when. Consequently without any authority on this point, application of the aggregate approach might be a reasonable approach, and any pre-distribution exchange negotiations at the partnership level would not taint the post-distribution exchange by the former partner.

V. MITIGATION OF DROP AND SWAP ISSUES

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

There are things that a partnership could do to enhance the legal support for treating a drop and swap transaction as a valid § 1031 exchange. Prudent tax advisers routinely advise the passage of as much time as possible between the drop and the swap, even if they know that the drop and the swap may follow each other closely. The passage of time ameliorates two of the issues that may haunt a drop and swap transaction--the holding requirement of § 1031 and the potential application of the *Court Holding* doctrine. As far as what period of time would be sufficient between the drop and the swap, advisors most conservatively cite a two year period based on language in PLR 8429039, or a one year period based on un-enacted proposed amendments to § 1031 proposed in the 1980s. Of course getting a taxpayer to wait one or two years to complete the transaction may be impossible from a practical point of view, so if the taxpayer can be convinced to wait until the next taxable year to complete the transaction, many tax advisors would be pleased. Note that technically it is not the passage of time that helps cure the infirmity in a drop and swap transaction. If the partners have the intent to do the swap on day one they would be tainted from day one no matter how long they wait to finish the transaction. But if there were no intent on day one to do an exchange, but there was a true change of intent the day after the drop, the exchange would be good from an analytical point of view. However, absent the ability of third parties to ascertain the partner's intent on the day of the distribution, the time gap between the drop and the swap becomes a de facto proxy for measuring intent.

VI. CONCLUSION

For the better part of a decade partnerships and partners have unhesitatingly relied on drop and swap transactions to facilitate the conclusion of a successful real estate partnership transaction. However, it is possible that the party might be coming to an end. The California Franchise Tax Board has begun to aggressively audit partnership § 1031 transactions, raising issues that the IRS would never think of addressing. Also, the 2008 Form 1065 for the first time contains a question directly aimed at the existence of drop and swap transactions. While there is no present indication that the IRS intends to question drop and swap transactions, if they were to change their minds they would have significant favorable legal arguments to make. As a result, partnerships might be forewarned to more carefully analyze their options before diving headfirst into future drop and swap transactions.