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Tax Planning for LLC and Partnership 1031 Exchanges (aka "Drop & Swaps")

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I. Introduction

1031 Exchanges (defined below) involving partnerships (or LLCs treated as partnerships, also referred to as "partnerships" in this outline) are hot. Appreciated real estate often is held by partnerships, and the partners thereof may have divergent views about whether to (1) sell the property, cash out, and distribute cash to the partners; (2) sell the property and "stick together" in a 1031 Exchange for new replacement property; (3) sell the property and go their separate ways in individual 1031 Exchanges for individual replacement properties; or (4) some combination of the prior choices. If all partners are unified in their exit strategy, the transaction can be simple (e.g., partnership-level 1031 Exchange). However, where the partners are determined to satisfy varying goals (e.g., one partner wants to cash out, one partner wants a separate 1031 Exchange, and the remaining partners want to stay together in a larger 1031 Exchange), the transaction can become extremely complex. This outline will discuss certain legal issues surrounding these partnership 1031 Exchanges.

II. Background

A. General Rules.

As a general rule, gain from the sale or exchange of property must be recognized for federal income tax purposes.[1] The gain that must be recognized is the excess of the amount realized from the sale or exchange over the taxpayer's adjusted basis in the property sold or exchanged.[2] Code Section 1031(a)(1) provides an exception to the general rule for exchanges of "like kind" properties held for productive use in a trade or business or for investment (a "1031 Exchange"). According to that section:

> 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 solely for property of like kind which is to be held either for productive use in a trade or business or for investment.[3]

Note the three elements of the test: (1) there must be an "exchange" of properties; (2) the properties must be held for use in a trade or business or for investment (the "Held For Test"); and (3) the properties must be of "like kind."

The underlying rationale for allowing nonrecognition of gain or loss is the concept that the taxpayer's economic situation after the exchange is fundamentally the same as it was before the

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[1] I.R.C. § 1001(a).

[2] *Id*.

[3] I.R.C. § 1031(a)(1).

transaction.[4] This is expressed in the Committee Report to the predecessor statute to Code Section 1031 as follows:

> [I]f the taxpayer's money is still tied up in the same kind of property as that in which it was originally invested, he is not allowed to compute and deduct his theoretical loss on the exchange, nor is he charged with a tax upon his theoretical profit.[5]

Although not explicitly stated in Section 1031, the same taxpayer that commences a 1031 Exchange by disposing of relinquished property must finish the 1031 Exchange by acquiring replacement property.[6] However, acquisitions via a "disregarded entity" – such as a single member LLC – would satisfy the "same taxpayer" requirement.

B. Exclusions.

The following interests are specifically excluded from 1031 Exchange treatment:

a. stock in trade or other property held primarily for sale;

b. stocks, bonds, or notes;

c. other securities or evidences of indebtedness or interest;

d. interests in a partnership;

e. certificates of trust or beneficial interests; or

f. choses in action

The exclusion of partnership interests was added to the Code in 1984.[7]

III. Issues Relevant to Partnership 1031 Exchanges

A. Introduction.

It is common for taxpayers holding property through a partnership (including limited liability companies treated as partnerships for income tax purposes) to attempt: (i) to dissolve and liquidate the partnership in order to permit each partner to separately sell or consummate a subsequent Section 1031 exchange, (ii) to distribute undivided interests in the relinquished

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[4] *See* Clemente, Inc., T.C. Memo 1985-367; Koch v. Comm'r, 71 T.C. 54 (1978); T.A.M. 9525002 (June 23, 1995).

[5] H. Rept. 704, 73d Cong., 2d Sess. (1934); 1939-1 C.B. (Part 2), 554, 564.

[6] *See* Chase v. C.I.R., 92 T.C. 874 (1989).

[7] References herein to the "Code" refer to the Internal Revenue Code of 1986, as amended (the "Code").