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Code Sec. 1031 Swap-and-Drops Thirty Years After *Magneson*

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Drop-and-Swaps

Drop-and-swap transactions continue to be a popular topic of discussion, even though no recent published guidance addresses them. A drop-and-swap typically occurs when members of a tax partnership decide to sell property and go separate ways, with some wishing to use the proceeds from the sale of the property to do an exchange individually under Code Sec. 1031 ("section 1031 exchange"). To accommodate their respective objectives, the members will often liquidate the tax partnership and to dispose of interests in the distributed property individually. Apparently some state taxing authorities are scrutinizing drop-and-swaps, but that scrutiny does not appear to have resulted in significant published guidance. Nonetheless, a brief review of drop-and-swaps would be timely as they continue to be popular transactions.[1]

Several variations of drop-and-swaps exist.[2] For instance, a tax partnership could transfer relinquished property, acquire several individual replacement properties, and distribute the replacement properties to its members. Obtaining total nonrecognition for the members doing exchanges with this type of distribute-last structure may be difficult, however, if some of the members of the tax partnership prefer to receive cash. If the tax partnership receives cash, it will recognize gain and may not be able to allocate all of the gain to members who will receive cash distributions. Instead of receiving cash, the tax partnership could receive an installment note and distribute it to cash-out members who would then receive payments and recognize gain under the installment method. Another shortcoming of these distribute-last structures is that they require members of a tax partnership to remain together longer than they would prefer. Once they have made a decision to divide the tax partnership, they are begging for trouble by remaining in the tax partnership longer than necessary. Consequently, members of tax partnerships often prefer to structure drop-and-swaps as a distribution followed by the exchange, and those distribute-first drop-and-swaps are the focus of this Article.

The objective of a member who receives distributed property and transfers it as part of an intended section 1031 exchange is that both the distribution and the exchange qualify for nonrecognition. Assuming the distribution can otherwise qualify for nonrecognition under the partnership tax rules, the focus turns to whether a distributee member's transfer can qualify for nonrecognition under Code Sec. 1031. Code Sec. 1031(a)(1) provides, among other requirements, that a person doing an exchange must hold relinquished property prior to the exchange (the holding requirement) and the purpose for holding the property must be for investment or business use (the use requirement). A practical aspect of drop-and-swaps is that

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[1] For a comprehensive analysis of drop-and-swaps see BRADLEY T. BORDEN, TAX-FREE LIKE-KIND EXCHANGES ¶ 7.1–7.10 (2nd ed. 2015). Depending upon the order of the transactions, alternative structures may be dubbed "swap-and-drops," but the term drop-and-swap also gets used to describe any type of transaction that includes a section 1031 exchange and proximate business restructuring. This article uses the terms to signify the order in which the transaction occurs.

[2] *See* BRADLEY T. BORDEN, TAX-FREE LIKE-KIND EXCHANGES ¶ 7.2[4] (2nd 2d. 2015); Bradley T. Borden, *Section 1031 and Proximate and Midstream Business Transactions*, 19 TAX MGT. REAL EST. J. 307 (Nov. 5, 2003).

they generally require the tax partnership to distribute property shortly before the purported exchange, so such transactions appear to implicate both the holding and use requirements—questions may arise as to whether the distributee member actually acquired the property for tax purposes and, if so, whether the member held the property for investment or business use. The law governing drop-and-swaps reveals, however, that members of tax partnerships can satisfy the holding and use requirements if they structure the transactions properly.

Any concern about the ability to satisfy the holding and use requirements is most likely attributable to an early expression of the IRS's understanding of the application of those requirements to drop-and-swaps. The IRS's position, as expressed in Rev. Rul. 77-337, is that a person who, as part of a prearranged plan, receives property in a tax-free distribution and immediately transfers it does not hold that property for investment or business-use. Furthermore, the entity's holding purpose cannot be attributed to the distributee. Consequently, based up on this reasoning, the distributee's exchange of distributed property cannot qualify for nonrecognition under Code Sec. 1031.[3] Courts have rejected this line of reasoning.

Not long after the IRS's ruling, the Ninth Circuit reached the opposite conclusion on similar facts in *Bolker v. Commissioner*.[4] The taxpayer in *Bolker* was the sole shareholder of the corporation and decided to liquidate the corporation.[5] On the day of the distribution, the taxpayer entered into a contract to transfer it as part of a section 1031 exchange.[6] The taxpayer transferred the distributed property three months after the distribution.[7] The court found that no other authority was directly on point, so it turned to the language of the statute.[8] It interpreted the statute to mean that a taxpayer satisfies the holding and use requirements by owning property that the taxpayer "does not intend to liquidate or to use for personal pursuits."[9] Thus, "the intent to exchange property for like-kind property satisfies the [use] requirement, because it is *not* an intent to liquidate the investment or to use it for personal pursuits."[10] That holding represents black-letter common law on the use requirement. All courts in the Ninth Circuit are bound by that law, and it is persuasive authority in all other parts of the country. The thirtieth anniversary of *Bolker* just passed, there are no contrary decisions from any other jurisdictions during that time, and the Tax Court's decision in *Bolker* also granted nonrecognition,[11] so any alternative expression of the law from a different court would be shocking.[12]

The law regarding the application of the holding and use requirements to drop-and-swaps is clear. Thus, for an intended drop-and-swap to fail to qualify for Code Sec. 1031 nonrecognition, it must fail one of the other requirements in Code Sec. 1031, or its structure must fail to accomplish its intended purpose of transferring tax ownership of the property from the tax partnership to the distributee member prior to the exchange.

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[3] *See* Rev. Rul. 77-337, 1977-2 C.B. 305 (ruling with respect to a distribution from a corporation under old Code Sec. 330, which permitted tax-free corporate distributions).
[4] *See* 760 F.2d 1039 (9th Cir. 1985) (ruling with respect to a distribution from a corporation under old Code Sec. 330, which permitted tax-free corporate distributions). A direct comparison of the facts in the revenue ruling and the case is not possible because the revenue ruling provides a cursory statement of the facts.
[5] *See* Bolker, 81 T.C. at 1040–41.
[6] *See id*. at 1041.
[7] *See id.*
[8] *See id.*
[9] *See id.* at 1045.
[10] *See id*. (emphasis in original).
[11] *See* Bolker v. Commissioner, 81 T.C. 782 (1983).
[12] Since the *Bolker* decision, the Tax Court has again granted Code Sec. 1031 nonrecognition to a drop-and-swap. *See* Mason v. Commissioner, 55 T.C.M. (CCH) 1134 (1988).

Title search: Code Sec. 1031 Swap-and-Drops Thirty Years After Magneson

Also available as part of the eCourse
The State of Section 1031 Drop-and-Swaps Thirty Years After Bolker and Magneson

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