UT LAW CLE THE UNIVERSITY OF TEXAS SCHOOL OF LAW

PRESENTED AT

70th Annual Taxation Conference

November 30 – December 1, 2022
Austin, Texas

How to Do (and Not to Do) Partnership Like Kind Exchanges — Drops, Swaps and Installment Notes

Stanley L. Blend
Michael L. Cook
Richard M. Lipton

I. Introduction[1].

A. Drop and Swap.

The term "drop and swap" originally conveyed a description of one type of exchange, a distribution from a partnership of an undivided interest in real property to one or more partners followed by an exchange of the distributed property for other real property. Eventually, the term became known to mean the various transactions involving partnerships that raised the holding purpose issues. Now, the first cousin issue is referred to as the "swap and drop" transaction. A party engages in an exchange and soon thereafter contributes it to another entity, usually a partnership, either a limited liability company or a limited partnership. This article deals with both types of transactions.

B. The Holding Purpose of Section 1031

Section 1031(a)(1) states as follows:

(a) Nonrecognition of Gain or Loss From Exchanges Solely in Kind.

(1) In General. – 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*.

The issue presented is whether the real property that is "dropped" out of the partnership (the "**Relinquished Property**")[2] to a partner was held by that partner for investment or productive use in a trade or business, or was it hold solely to swap for another property. Conversely, in the swap and drop transaction, was the property received in the swap (the "**Replacement Property**") held for investment or the productive use in a trade or business or was it held for a drop into an entity? The "drop and swap" comes in varying fact patterns that call for varying solutions. For example, assume a partnership has five partners A, B, C, D and E, each having a 20% interest. The partnership has a single parcel of real estate having a value of $10.0 million, basis of $3.0 million and debt of $4.0 million. The partnership has executed a contract to sell the property for cash.

Situation One. A, B and C want to exchange the property for one or more parcels of real property they will jointly own. D and E want to take cash.

---

[1] Most of the analysis in this outline are summaries from Dick Lipton's 2003 article in the Journal of Taxation, "The 'State of the Art' in Like-Kind Exchanges, Revisited". Even though it is 20 years old, except for the 2018 change (Footnote 2), the article remains an excellent synopsis of current law on the broad spectrum of Section 1031 exchanges.

[2] After December 31, 2017, the only property eligible for tax free exchange treatment is real property. IRC §1031(a)(1).

Situation Two. A and B want to exchange for a property that they will jointly own. C, D and E want cash.

Situation Three. All of the partners want to exchange but not into jointly own properties; they want to exchange into separate individual parcels.

This presentation will address these three differing variations of the "drop and swap".

II. Staking Out Positions.

A. The Rulings.

Beginning in the 1970s and into the early 1990s, the IRS vigorously attacked the "drop and swap" transactions with little success, indeed, perhaps none. For the last thirty years the IRS has apparently abandoned the effort, yet the IRS will not bless the "drop and swap" concept nor any of its cousins. The issue is (i) whether relinquished property acquired in the "drop" immediately prior to a like-kind exchange satisfies the "held for" requirement under Section 1031(a)(1); or, in the reverse case of the swap and drop, (ii) whether replacement property acquired immediately before a contribution of that property to another entity satisfies the "held for" test.

1. In Rev. Rul. 75-291, 1975-2 CB 332, corporation Y entered into a written agreement to acquire land and a factory owned by unrelated corporation X. Pursuant to this agreement, Y acquired another tract of land and constructed a factory on this land, and then exchanged the land and new factory for X's land and factory. Because Y acquired the property transferred to X "immediately prior to the exchange," the IRS concluded that Y "did not hold such relinquished property for productive use in its trade or business or for investment." Thus, as to Y, the exchange did not qualify for nonrecognition of gain or loss under Section 1031(a). [But, did Y care because Y's basis in the recently acquired land and constructed property would approximate or equal the value of X's property received by Y.

2. Rev. Rul. 77-297, 1972-2 CB 304, involved taxpayer A, who agreed to sell a ranch with the stipulation that the buyer (B) would cooperate to effectuate an exchange of properties should A locate suitable property. Once A located another ranch, owned by C, B purchased C's ranch and then exchanged this ranch with A for A's ranch. With regard to B, the IRS concluded that the exchange of ranches did not qualify for nonrecognition of gain or loss under Section 1031 because "B did not hold the second ranch for productive use in a trade or business or for investment." In reaching this conclusion, the IRS cited Rev. Rul. 75-291, in which "it is held that the nonrecognition provisions of section 1031 do not apply to a taxpayer who acquired property solely for the purpose of exchanging it for like-kind property."

3. In Rev. Rul. 77-337, 1977-2 CB 305, the IRS considered whether property acquired immediately prior to a like-kind exchange, through the liquidation of the taxpayer's wholly owned corporation, could satisfy the "held for" requirement. Individual taxpayer A was the sole owner of the stock of corporation X, which owned a shopping center. Under a prearranged plan, A first liquidated X and thereby acquired the shopping

UT LAW CLE THE UNIVERSITY OF TEXAS TEXASLAW

Find the full text of this and thousands of other resources from leading experts in dozens of legal practice areas in the UT Law CLE eLibrary (utcle.org/elibrary)

Title search: Drop and Swap Panel

First appeared as part of the conference materials for the
70th Annual Taxation Conference: Day 2 - Business Transactions session
"Drop and Swap Panel"