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1031 Exchanges: Recent California Developments on "Drop-and-Swap" and "Swap-and-Drop" 1031 Exchanges Involving Partnerships and LLCs

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Investments in real property are often held through limited partnerships or limited liability companies ("LLCs") taxed as partnerships for tax purposes (collectively, "Tax Partnerships") for a variety of reasons, including certain tax advantages. By contrast, entities taxed as corporations tend to be a poor choice for holding real property due to, among other things, the difficulties of transferring real property out of the entity without recognizing taxable gain.

Eventually, all good things must come to an end, and certain tax complications may arise when a Tax Partnership wishes to dispose of its real property assets. It may be the case that the Tax Partnership simply sells its real property and distributes the proceeds from the sale to each of its owners in liquidation of their interest in the Tax Partnership. This transaction would be taxable to the owners of the Tax Partnership, typically at long-term capital gains rates subject to some exceptions. It is often the case, however, that the owners desire to take advantage of the tax benefits of exchanging the Tax Partnership's real property in a transaction qualifying under Section 1031 of the Internal Revenue Code of 1986, as amended ("Section 1031").

Under Section 1031, a taxpayer exchanging property for like-kind property in a continuation of its investment defers taxation on the gain or loss realized on the disposition of the property. Generally, to qualify as a Section 1031 exchange transaction (a "1031 Exchange"), a taxpayer must exchange property held for productive use in a trade or business or for investment for other like-kind property that is also to be held for productive use in a trade or business or for investment.

Notably, however, Section 1031 specifically prohibits a 1031 Exchange into or out of an interest in a Tax Partnership, including, for avoidance of doubt, an interest in an LLC taxed as a partnership. Therefore, an interest in a Tax Partnership cannot be exchanged in a 1031 Exchange for an interest in real property, or vice versa, without recognition of gain. This prohibition often makes it difficult to both accomplish desired business objectives and complete a 1031 Exchange.

One common structure historically used by tax advisors to plan around the prohibition against exchanging interests in a Tax Partnership is called a "drop-and-swap." In one variation of a "drop-and-swap" transaction, the Tax Partnership dissolves, distributing all of its real property to its owners pro rata as tenants-in-common. Each co-tenant then either exchanges his or her real property interest for like-kind replacement property in a 1031 exchange or, alternatively, sells his or her real property interest for cash in a taxable transaction. It is important to note, however, that the difference between a tenancy-in-common and a partnership for tax purposes is often unclear, and questions often arise as to whether the ownership arrangement is truly a co-tenancy or a partnership for tax purposes.

Another common structure historically used by tax advisors to plan around the prohibition against exchanging interests in a Tax Partnership is called a "swap-and-drop." In a "swap-and-drop" transaction, a taxpayer exchanges real property for like-kind replacement property in a 1031 Exchange, and then following the 1031 Exchange, the taxpayer contributes the like-kind replacement property to a Tax Partnership, in exchange for interests in the Tax Partnership.

California generally follows federal law with respect to its treatment of 1031 Exchanges, with certain exceptions. Notably, in recent years, the California Franchise Tax Board

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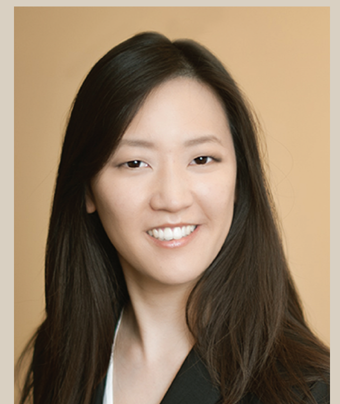

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("FTB") has closely scrutinized both "drop-and-swap" and "swap-and-drop" transactions, and has challenged their treatment as 1031 Exchanges. In challenging "drop-and-swap" and "swap-and-drop" transactions, among other issues, the FTB has focused on the holding requirement for 1031 Exchanges, which requires that a taxpayer hold 1031 Exchange property for productive use in a trade or business or for investment. In a "swap-and-drop" context, the FTB has argued that a taxpayer does not satisfy the holding requirement if, following the receipt of replacement property in a 1031 Exchange, the taxpayer then contributes, or "drops," the property into a Tax Partnership. In the FTB's view, the transaction does not meet the holding requirement because: (1) the taxpayer's exchange of property for interests in a Tax Partnership changed the taxpayer's form of ownership in the investment such that the taxpayer could not be considered to have held the property for investment prior to the purported 1031 exchange, or (2) the taxpayer has essentially impermissibly exchanged real property for interests in a Tax Partnership.

In a taxpayer-friendly decision published earlier this year, the California State Board of Equalization ("BOE") issued a precedential decision in *Rago Development Corp.*, 2015-SBE-001 (June 23, 2015), reversing the FTB's denial of 1031 Exchange treatment in a "swap-and-drop" transaction. In *Rago*, two groups of taxpayers sold their respective properties in a 1031 Exchange for a tenancy-in-common interest in replacement property. Pursuant to the terms of a loan agreement entered into by the taxpayers in connection with the purchase of the replacement property, the taxpayers were required to transfer their interests in the replacement property into a single-purpose LLC within seven months after acquiring the replacement property. After holding the replacement property as tenants-in-common for seven months, the taxpayers contributed their respective interests in the replacement property into a new LLC in accordance with the terms of the loan agreement. Following the transfer to the LLC, the taxpayers held the same percentage interests as they held as tenants-in-common, and the LLC's sole asset was the contributed property.

The FTB challenged the transaction in *Rago* on grounds that the taxpayers did not hold the property for investment prior to the exchange because the taxpayers subsequently contributed the property to an LLC seven months after the exchange, and on grounds that the transaction was in essence an impermissible exchange of property for interests in an LLC.

In finding that the transaction qualified as a 1031 Exchange, the BOE in *Rago* rejected both arguments brought by the FTB. The BOE first found that the taxpayers intended to hold the property for investment, and that the taxpayer's subsequent transfer of the property to the single-purpose LLC did not negate the taxpayer's intent to hold the property for investment. In so finding, the BOE noted that the taxpayer's intent was evidenced by the fact that the taxpayers in fact held the property for seven months as tenants-in-common prior to contributing the property to the LLC, and also by the fact that the transfer to the LLC was required by the lender under the loan agreement, and was not completed solely for tax planning purposes.

Next, the BOE found that the transaction could not be recharacterized as simply an invalid exchange of property for interests in an LLC, as each of the steps, the "swap" followed by the "drop," of the transaction had independent economic significance.

In summary, the *Rago* case represents a taxpayer beneficial opinion that, as a cited precedential opinion, should guide the FTB in its evaluation of 1031 Exchanges going forward. Although beneficial, in light of the FTB's willingness to challenge both "drop-and-swap" and "swap-and-drop" transactions and the fact that the decision only applied to a "swap-and-drop" transaction, there remains the possibility that the FTB may limit the *Rago* case to its facts and not apply similar reasoning in cases with different fact patterns. In any event, *Rago* represents a step forward, and "drop-and-swap" and "swap-and-drop" transactions remain viable options, if correctly structured, to satisfy the needs of owners desiring to liquidate their interests in a real estate investment through a Tax Partnership.

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