

LIKE KIND EXCHANGES – IRC 1031 EXCHANGES INVOLVING PARTNERSHIPS OR LLCs

A like kind or 1031 exchange provides for non-recognition of gain or loss on the exchange of property solely for property of a like kind that is held for productive use in a trade or business or for investment. In order to qualify for 1031 non-recognition treatment, three elements must be satisfied: (1) the property transferred by the taxpayer must be held either for productive use in a trade or business or for investment, (2) the property received by the taxpayer must be held either for productive use in a trade or business or for investment, and (3) the properties transferred and received must be of like kind.

The exchange must be completed by the same taxpayer. For the purpose of a 1031 exchange, a partnership or an LLC is viewed as a separate entity rather than as an aggregation of its partners or members. Therefore, a partner in a partnership or a member of an LLC cannot use the proceeds from the sale of a property held in a partnership or an LLC to qualify for 1031 treatment in his individual capacity. However, there are several strategies for completing a 1031 exchange involving property held in an LLC.

DROP AND SWAP

The “drop and swap” is the most commonly used strategy in the situation where some LLC members want to reinvest their gain in investment property and other members want to cash out. Under the drop and swap strategy, the LLC deeds the property to the members individually to hold as tenants in common and then the members sell the property in their individual capacities. However, the holding period for determining whether the property was held for investment is not tacked when the property is deeded to the members individually as tenants in common. Therefore, the LLC members would need to plan well in advance of the sale of the property to use this strategy. The Tax Code and Treasury Regulations are silent as to how long a property must be held to satisfy the “held for investment” requirement. Private Letter Ruling 8429039 indicates that two years would be sufficient. Presumably if the property appears on two years of K-1 tax filings in the individual name of the owners, the holding period would more likely than not be sufficient. A concern would arise, however, if the plan was prearranged and the property was deeded to the members as tenants in common after the terms of the sale were negotiated.

SWAP AND DROP

Another strategy is the “swap and drop” in which the LLC engages in a 1031 exchange and then the member who wants to cash out either sells his membership interest or title is dropped to that member and he sells his interest in the property. While this strategy eliminates concerns about the satisfying the holding requirement for the relinquished property, it may still be subject to step transaction treatment if the replacement property is not held by the LLC for a sufficient period of time prior to a member selling his membership interest or title being transferred to a member. However, the IRS would not likely challenge the transaction, even if it is part of a prearranged plan, if the new property continues to be held for investment by the members after the title is dropped to them individually as tenants in common. In *Maloney*, a

corporation made an exchange of like kind property held for investment with the intention to liquidate the corporation and distribute the acquired property to the shareholders, who would then hold the property for investment. The Tax Court found that the exchange qualified for 1031 treatment on the basis that the investment was not cashed out and was the continuation of the old investment in a modified form. Maloney v. C.I.R., 93 T.C. 89, 96 (1989).

The swap and drop strategy is particularly useful when all of the members of an LLC wish to pursue a 1031 exchange, but would like to own the acquired property or properties in their individual capacity. For example, a three-member LLC could purchase three separate properties held for investment in a 1031 exchange and then drop title to each property to an individual member. This allows each member of the LLC to receive the benefits of a 1031 exchange without continuing their investment as a member of the LLC.

SPLIT OFF

A “split off” is a strategy in which the LLC distributes a property interest to the exiting member, as a tenant in common with the LLC, while the remaining members pursue a 1031 exchange through the LLC. Although the strategy avoids the “held for investment” requirement issue, it may be subject to attack under the step transaction doctrine.

INSTALLMENT NOTE

Under the 1031 plus installment note strategy, the property is purchased for cash and an installment note. The continuing members then use the cash in a 1031 transaction and the installment note (the boot) is distributed to the departing member in liquidation of his membership interest. Structuring the transaction to include an installment note avoids special allocation issues related to the entire cash boot being allocated to one member in the year of the exchange. However, it also requires the buyer to agree to structure the deal to include an installment note. Nevertheless, the deal could be structured so that the note is paid in full in the second year and it would still qualify as an installment sale under section 453.