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Planning for a Drop and Swap

The "Drop and Swap" term

"Drop and Swap" is a term used to describe the process of dropping out of a partnership or membership interest of a limited liability company (LLC) into an ownership interest in investment real estate and then exchange or swap for new investment real estate. The objective is to get into a position that allows you to exchange your real estate into new real estate and defer the taxes due on your gains. There are pros and cons of a drop and swap and several variations all of which can be complicated, but a drop and swap is a valuable planning strategy to hang onto your hard earned gains.

Partnership or LLC is the owner

When multiple people come together to buy real estate, it is very common for them to form a partnership or a limited liability company (LLC) to hold the title to the property. This form of ownership typically has its own tax identification number and files its own tax return. In most cases the income and expenses are distributed to the owners of the partnership on an IRS form K-1. Many people have the mistaken understanding that they own real estate when, in fact, they own an interest in an entity which owns the real estate.

1031 exchange

When it is time to sell the real estate and the real estate has gain, Uncle Sam and Aunt NC want a percentage of the gain. Section 1031 of the tax code allows the owner of property to exchange/swap for new replacement property and defer paying the taxes. The process defined in Treasury Regulation 1.1031, has very specific steps and timing parameters to accomplish an exchange properly. If a partnership or LLC own the real estate, the partnership or LLC can do an exchange, as it is a tax entity, filing a tax return under its own tax ID number. The individual partners or members cannot exchange their interests; the code is very clear on this issue (IRC §1031(a)(2)(D)).

It is very common that not everyone in the partnership wants to remain in the partnership and buy new replacement property(ies). Typically each member wants to go in their own direction. Some don't want to pay taxes, and others are willing to do so.

Plan for the eventual sale and don't wait to restructure

The language of the 1031 law says you can exchange property that was held for investment or business purpose for new investment or business replacement property to be held. The only way to defer taxes is to actually own the real estate and exchange for new real estate. The "Drop and Swap" strategy is to drop out of the partnership into a percentage ownership interest in the real estate. As an example if three people are equal members of an LLC which owns a rental beach house, the drop and swap strategy would have them terminate the LLC, file a final tax return for the LLC, and distribute the ownership of the real estate to the members. This would be changing the title of the rental beach house to reflect three individual tenants-in-common owners. The tenant-in-common owners should then have a tenant-in-common agreement reflecting how the property should be managed - Similar to a partnership agreement, but for tax purposes, not a partnership.

The terms "held" and "hold" in the law do not define a time period, but define intent. A taxpayer doing an exchange must have had the intent to hold the property. Time is one of many ways to prove intent. If you hold a property for a period of a year, then it is fairly clear your intent was to hold an investment property.

When planning for an eventual sale, the drop and swap objective is to get out of the partnership or LLC and into an actual ownership of the real estate so that you have the opportunity to do an exchange on your own interest.

Advice from the 1031 industry

The advice from the 1031 industry on a drop and swap has several steps. Drop out of the entity as soon as you can and into individual ownership long before showing any intent to sell. When you put the property on the market to sell, you have tipped your hand you intend to sell. Do not mix the two business decisions, dropping into individual ownership and selling together. If you mix the two decisions together, the IRS could easily argue your intent was to take a series of steps to avoid taxes.

When you drop all owners into individual ownership, dissolving the partnership, or LLC, file a final tax return.

Put some time on your ownership of the real estate, proving your (and your tax ID number) intent is to hold an investment property.

If you want liability protection, each owner could own their individual real estate interest in their own single member LLC.

Set up a co-ownership agreement with the other owners. Share expenses, profits, etc. IRS Revenue procedure 2002-22 is a good guide on the critical components.

Be aware of a couple of questions on the partnership tax return Form 1065. Questions 13 and 14 on Schedule B ask if there was any drop and swap activity.

There are plenty of variations, and each situation is a little different. Owning property in a partnership and making decisions together can be like herding cats.

"Drop and Swap" is an important strategy to get into position to exchange real estate and defer taxes. Any time you are changing from one form of ownership to another, it is important to get good legal and tax help. Don't do this on your own. Making yourself aware of the planning opportunity is the first step to keeping your investment dollars at work.

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