"Structuring the "Drop and Swap" Exchange"

By Richard A. Goodman[1]

May 27, 2004

The most common type of tax-deferred exchange undertaken by partners seeking to exchange out of partnerships is commonly referred to as the "drop and swap" exchange. In such an exchange, a partnership owning real property about to be sold distributes undivided fractional interests ("UFIs") in that property to its partners. The partners then sell the UFIs, and those partners who wish to effect tax-deferred exchanges acquire replacement properties.

Conceptually, the IRS should have no objection to a "drop and swap" exchange since distributions of property from partnerships generally are not taxable events.[2] However, the IRS long has contested not only "drop and swap" exchanges, but other types of exchanges involving partners and partnerships.

Fortunately, both the tax court and the Ninth Circuit Court of Appeals have approved a "drop and swap" exchange in which the relinquished property was distributed by a corporation wholly owned by the taxpayer.[3]

Similarly, both the tax court and the Ninth Circuit Court of Appeals have approved a tax-deferred exchange which was immediately and by pre-arrangement followed by a contribution of that property into an entity.[4]

The tax court also has approved an exchange in which a partnership effected a tax deferred exchange and then distributed the replacement property to the exchanging partner and cash to the selling partner.[5]

Notwithstanding these setbacks, the IRS and the California Franchise Tax Board[6] have continued to challenge exchanges involving partners and partnerships. In this author's

---

[1] [1] Richard A. Goodman is a partner in the law firm of Goodman & Levine LLP with offices in Oakland, California. He is the author of *Real Property Exchanges* (California CEB 1982) and of numerous articles relating to tax-deferred exchanges. As part of his transactional real estate practice, Mr. Goodman represents taxpayers and qualified intermediaries with regard to tax-deferred exchanges. His web address is: www.the1031attorney.com. Nothing in this article constitutes legal or tax advice. Taxpayers always should consult their own tax and legal advisors as to their particular transactions.

[2] IRC §§ 731(a)(1), 733.

[3] *Joseph R. Bolker* 760 F.2d 1039 (9th Cir. 1985) affg. 81 T.C. 782 (1983.). In *Bolker*, the IRS contended that the taxpayer never held the relinquished property for a proper purpose, namely, for investment or in a trade or business. The court, however, held that since the taxpayer never intended "to liquidate the investment or use it for personal pursuits," he held the relinquished property for a proper purpose.

[4] *Magneson v. Commissioner* (1988) T.C. Memo 1988-273, aff'd (9th Cir. 1985) 753 F.2d 1490.

[5] *Maloney* (1989) 93 T.C. 89. In that case, a corporation exchanged its relinquished property for the replacement property and then distributed the replacement property to its shareholders. The IRS contended that the exchange was impermissible because the corporation never intended to retain the replacement property for business or investment purposes but acquired the replacement property only to distribute to its shareholders. However, the tax court ruled in favor of the taxpayer, determining that the corporation held the replacement property for investment notwithstanding its subsequent transfer of the replacement property to the shareholders.

experience, a "drop and swap" exchange is most likely to be challenged by the IRS on the basis of *Delwin E. Chase*[7] and/or Rev. Proc. 2002-22.[8] It is useful, therefore, to analyze these authorities to consider their relevance to "drop and swap" exchanges.

The *Chase* Case

In *Chase*, a limited partnership called John Muir Investors ("JMI") owned an apartment complex (the "Apartments"). In January 1980, JMI entered into a contract to sell the Apartments. Also in January 1980, the taxpayer, who was one of two general partners of JMI, caused JMI to distribute to him a deed as to an undivided 46.3527% interest in the Apartments in liquidation of his 46.3527% interest in JMI, but he did not record that deed. Delivery of that deed constituted a violation of JMI's partnership agreement.

That contract subsequently expired and in March 1980, JMI signed a letter of intent to sell the Apartments to RWT Enterprises, Inc. ("RWT"). This letter of intent did not indicate that RWT believed or had any reason to believe that the taxpayer had any ownership interest in the Apartments. The letter of intent also failed to mention any duty on the part of the taxpayer to pay a pro rata portion of the real estate brokerage commission which would be payable as a result of the sale.

Prior to close of escrow, the taxpayer signed the escrow agreement on behalf of JMI but not on his own behalf, even though he was the purported owner of an undivided interest in the Apartments. Not until June 12, 1980, when it was clear that the sale to RWT would be consummated, did the taxpayer record the deed from JMI. The next day, the taxpayer entered into an exchange agreement with RWT and an exchange intermediary (the "Ellis Trust").

Although the deed purportedly was transferred to the taxpayer in January 1980, he did not pay any of the expenses of the property between that date and close of escrow and did not receive any share of the rental income during this period.

In July 1980, escrow closed on the sale of the Apartments. Of the net proceeds of $9,210,876, the amount of $3,799,653 was paid to the Ellis Trust even though that amount exceeded the 46.3527% interest it should have received. The reason was that the taxpayer had specifically instructed the escrow holder to ignore the written escrow instructions requiring 46.3527% of the net proceeds to be transferred to the Ellis Trust. Instead, the portion of the proceeds distributed to the Ellis Trust represented the distributive share of the net proceeds to which the taxpayer, in his capacity as a limited partner of JMI, was entitled.

---

[6] The authorities which govern tax deferred exchanges for federal income tax purposes are determinative for California income tax purposes, as well. California Rev. and Tax. Code § 18031.
[7] 92 T.C. 53 (1989)
[8] 2002-14 IRB 1 (March 19, 2002)

In analyzing the purported exchange, the court in *Chase* started by citing *Bolker* approvingly*:*

> "To qualify for nonrecognition, a taxpayer must satisfy each of the specific requirements as well as the underlying purpose of section 1031 (a). *Joseph R. Bolker* (1983) 760 F.2d 1039 (9th Cir. 1985) affg. 81 T.C. 782 (1983.) We must determine whether the "exchange" requirement of that section was satisfied. Respondent argues that the substance over form doctrine is applicable to impute the disposition of the Apartments entirely to JMI and concludes that, in substance, petitioners did not "exchange" any part of the Apartments."

The tax court disallowed the exchange, but it did so *only* because its form did not comport with its substance: The taxpayer in *Chase* never acted or was treated as the owner of an undivided 46.3527% interest in the Apartments: He concealed the delivery of the deed; he held the deed, unrecorded, for many months; he did not share in the economic income and expenses during his alleged ownership of that interest; and his exchange intermediary received a distribution consistent with the taxpayer's interest as a limited partner and *inconsistent* with the taxpayer's purported ownership of an undivided 46.3527% interest in the Apartments.

An IRS market segment paper, used for training purposes, states that, "*Chase v. Commissioner* should be cited in situations where the form of the transactions fail to reflect the economic realities of the transactions."[9]

Rev. Proc. 2002-22

The Service long has acknowledged that UFIs may be exchanged under IRC § 1031.[10] However, the IRS recently issued Rev. Proc. 2002-22, which sets forth the documents which must be supplied and the tests which must be met in order to obtain a ruling from the IRS as to an exchange of an UFI.

Rev. Proc. 2002-22 starts by discussing the differences between UFIs and partnership interests. The mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity (such as a partnership) for federal tax purposes.[11] By contrast, partnerships are created where parties join together with the intent of conducting a business and of sharing profits and losses, especially if the economic benefits to the participants are not proportional to the UFIs.[12]

To illustrate the characteristics of valid UFIs, Rev. Proc. 2002-22 cites a revenue ruling[13] which held that no partnership existed even though:

---

[9] MSSP: Partnerships (9/02)
[10] Rev. Rul. 79-44. *See also* Ltr. Rul. 199926045 and 199945046.
[11] Regulation § 301.7701-1(a)(2)
[12] Rev. Proc. 2002-22, Section 2
[13] Rev. Rul. 75-374, 1975-2 C.B. 261

> …the co-owners employed an agent to manage the apartments on their behalf; the agent collected rents, paid property taxes, insurance premiums, repair and maintenance expenses, and provided the tenants with customary services, such as heat, air conditioning, trash removal, unattended parking, and maintenance of public areas. … .the agent's activities in providing customary services to the tenants…were not sufficiently extensive to cause the co-ownership to be characterized as a partnership.[14]

By contrast, Rev. Proc. 2002-22 a Ninth Circuit Court of Appeal case, *Bergford v. Commissioner*,[15] as illustrative of a tax partnership, in which 78 "co-owners" were governed by an agreement containing the following provisions:

> …the co-owners authorized the manager to arrange financing and refinancing, purchase and lease the equipment, collect rents and apply those rents to the notes used to refinance the equipment, prepare statements, and advance funds to participants on an interest-free basis to meet cash flow. The agreement allowed the co-owners to decide by majority vote whether to sell or lease the equipment at the end of the lease. Absent a majority vote, the manager could make that decision. In addition, the manager was entitled to a remarketing fee of 10 percent of the equipment's selling price or lease rental whether or not a co-owner terminated the agreement or the manager performed any remarketing. A co-owner could assign an interest in the co-ownership only after fulfilling numerous conditions and obtaining the manager's consent.[16]

Having laid this groundwork, Rev. Proc. 2002-22 then sets out a list of conditions which must be satisfied before the IRS will issue an advance ruling that a particular co-ownership will not be treated as a partnership for tax purposes. Many of those conditions are inapplicable to "drop and swap" exchanges. Others are uncontroversial, such as the requirement that the Co-owners must hold title to the property as tenants-in-common under local law[14] and that the co-ownership may not conduct business under a common name or file a partnership or corporate tax return.[15]

One of the most significant of the conditions is that the Co-owners must retain the right to approve the sale of the property, and such sale must require the *unanimous* approval of the Co-owners.[23] However, Rev. Proc. 2002-22 softens this condition by providing that a co-ownership agreement may permit many decisions to be made by a majority vote of the Co-owners.[16]

[14] Rev. Proc. 2002-22, Section 2
[15] 12F.3d 166 (9th Cir.1993)
[16] Rev. Proc. 2002-22, Section 2. See also *Bussing v. Commissioner*, 88 T.C. 449 (1987), *aff'd on reh'g* 89 T.C. 1050 (1987)
[14] Rev. Proc. 2002-22, Section 6.01
[15] Rev. Proc. 2002-22, Section 6.03. Presumably, a name by which the property is operated would not be deemed to be a "common name."
[23] Rev. Proc. 2002-22, Section 6.05. From an economic standpoint, control is a two-edged sword, as the unanimous vote requirement for sale, refinance, or lease of the property also enables a single dissident Co-owner to thwart, at least temporarily, the wishes of the other Co-owners.
[16] Rev. Proc. 2002-22, Section 6.05

The other important condition is that Co-owners must share in all revenues and all costs of the property in proportion to their undivided interests in the property[27] and they must be responsible for their pro-rata share of all blanket indebtedness against the property.[28]

Thus, the conditions set forth in Rev. Proc. 2002-22 are straightforward and fairly easy to meet in the context of a "drop and swap" exchange. Furthermore, the inability to meet one or more of those conditions is *not* grounds for disallowance of a "drop and swap" exchange, but *only* means that an advance ruling cannot be obtained!

Structuring the "Drop and Swap" Exchange

Far from precluding "drop and swap" exchanges, *Chase* and Rev. Proc. 2002-22, taken together, offer a veritable road map for structuring such exchanges. In particular:

- Regardless of whether the partnership owns assets other than the property being sold, the partnership should be *completely* liquidated pursuant to a written agreement before the UFIs are distributed to the partners.[17]

- If only a portion of the property is being sold, the partnership should, pursuant to a written agreement, *redeem* the partnership interests of the partners to whom UFIs are being distributed.

- If possible, the UFIs should be distributed before the property is marketed and the partners, as owners of the UFIs, should sign the purchase agreement.

- If the property is marketed *before* the UFIs are distributed, the purchase agreement should provide for that distribution and for performance by the partners of the partnership's obligations. Furthermore, the brokers, the escrow holder and the title company all should be notified in writing of the distributions and of the partners' intentions to effect tax-deferred exchanges of their UFIs.

- The partnership's final tax return should reflect no income or loss from the relinquished property after the distribution of the UFIs. Conversely, from that date forward, the partners should report on their individual federal and state income tax returns their pro rata share of *all* items of income and loss on the UFIs.

- The net proceeds of sale distributed to the exchange intermediaries should be consistent with the undivided interests owned by the partners, even if such distributions are *inconsistent* with the partnership agreement.

---

[27] Rev. Proc. 2002-22, Section 6.08

[28] Rev. Proc. 2002-22, Section 6.08. Of course, if the financing initially was non-recourse, it will continue to be non-recourse as to the Co-owners.

[17] In *Bolker*, the liquidation was a complete liquidation, a fact mentioned in the decisions of both the tax court and of the Ninth Circuit Court of Appeals.

- A tenancy in common agreement governing relations among the partners after the liquidation should require unanimous consent for sale of the property but it safely may permit *majority* vote on a number of items, as detailed in Rev. Proc. 2002-22.

Conclusion

Although the IRS may challenge a “drop and swap” exchange, it *should* survive an audit if care is taken in its structuring, and, in particular, if the economic substance of the transaction is consistent with its form.