Are 1031 Drop & Swap Real Estate Exchanges in Jeopardy in California?

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ARE 1031 DROP & SWAP REAL ESTATE EXCHANGES IN JEOPARDY IN CALIFORNIA?

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Given the current state of the real estate market, more and more taxpayers find themselves with real properties that are either vacant or facing difficulty in filling leases, that they would like to sell, and they may desire to roll their sale proceeds into new real estate in a tax-deferred, like-kind exchange under Internal Revenue Code ("IRC") Section 1031. Section 1031 provides that no gain or loss is recognized on an exchange of like-kind property that is used in a trade or business or held for investment.[2] However, Section 1031 does not apply to "stocks, bonds . . . notes, [or] other securities or evidences of indebtedness or interest."[3] Since 2018, Section 1031 has only applied to real property. Before that, people swapped planes, radio and TV stations, artwork, and crypto.[4] But now, Section 1031 has returned to its roots, just swaps of real estate.

Most states conform to this storied provision, even California, although California has special rules where California property is exchanged for non-California property.[5] Most swaps are not simultaneous, of course, since you usually do not find two parties who want exactly what the other has. Most exchanges are delayed, with at least three parties, and a qualified intermediary who holds the funds. There are stringent timing requirements for deferred exchanges with respect to identification of the replacement property and the closing date for the replacement property.[6] The replacement property, for deferred forward exchange, must be identified within 45 days and received by earlier of: (1) 180 days following the sale or (2) the due date of the transferor's return for the year in which the property is relinquished.[7] There are also holding purpose requirements and qualified use requirements that the Taxpayer must comply with to have a valid 1031 exchange.[8]

This article provides a broad survey of the recent developments for 1031 Drop and Swap exchanges within California. The article discusses common audit issues for Drop and Swap exchanges, a selection of seminal caselaw, and recent precedential decisions. In particular, the article examines the impact of these recent cases on the utility of a Drop and Swap exchanges. This article discusses several steps that taxpayers can take to minimize the audit risk for their Drop and Swap exchange. The article also briefly discusses alternatives to the Drop and Swap structure that taxpayers can utilize to exchange their property.

SECTION 1031 DROP AND SWAP

When partners of a partnership or members of a limited liability company want to leave that association, some partners may want to cash out of their investment, while others may want to undertake a Section 1031 exchange for their share of the partnership's property. To accommodate these various goals, a partnership may distribute undivided interests in its property as a prelude to a future exchange of those property interests. The partnership enters a "Drop and Swap" transaction, and a partner "drops" himself from the partnership.

A Drop and Swap transaction proceeds as follows: First, title to an undivided interest in the partnership's property is transferred out to one or more of the partners in redemption of their interest. The undivided interest in the property is then generally held as tenants-in-common ("TIC"). Second, the partner "swaps" into a replacement property. The TIC interests are exchanged. In essence, the mechanics of the Drop and Swap changes the property title in the partnership, removing individual names to achieve the transfer.

Historically, 1031 Drop and Swap exchanges were not used by owners of real estate. There were significant difficulties with satisfying the identification and replacement property

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timing requirements. A fractional ownership interest, such as a TIC interest, was one solution to this problem. However, there were considerable risks with using TIC interests. The government had characterized TIC interests as a partnership interest, which is not allowed in 1031 exchanges under IRC section 1031(a)(2)(D).[9]

In 2002 the IRS published Revenue Procedure 2002-22 which sets forth requirements under which the IRS would rule favorably that a TIC arrangement involving rental real estate would be treated as ownership of real estate or a partnership for tax purposes.[10] Many practitioners consider this effectively as a safe harbor for ensuring TIC interests qualify as like-kind property in 1031 exchanges, although it is worth noting a certain amount of noncompliance is accepted by the market as not causing loss of the TIC status. A discussion of all the factors in Revenue. Procedure 2002-22 is beyond the scope of this article, but many syndicators have complied with the requirements in this procedure. This has led to the growth of TIC interests and Drop and Swap exchanges in the 1031 industry since 2002.

The adoption of TIC interests in 1031 exchanges expanded the universe of replacement properties, since a TIC interest could allow investors access to institutional grade property that would normally be cost prohibitive for them to purchase outright. The TIC offerings also provided taxpayers with the potential to diversify into multiple properties with fewer dollars. This new revenue procedure made it possible for Drop and Swap exchanges to become a more feasible and a realistic option for taxpayers that want to sell their real estate for cash and those that want to swap their undivided interests for other real property interests.[11]

CALIFORNIA'S VIEW OF DROP AND SWAP EXCHANGES

Many real estate and tax professionals undertake Drop and Swap exchanges routinely. Certified exchange specialists, 1031 advisors, law firms, and accounting firms openly advertise and offer Drop and Swap transactions as part of the regular services they provide. Drop and Swaps are not often questioned by the IRS, but California has taken an aggressive stance towards these type of 1031 exchanges. In 2007 the Franchise Tax Board ("FTB") published a notice stating that the agency would examine Drop and Swap exchanges involving TIC interests.[12]

The common structure for a Drop and Swap exchange, as described in Part I, has been to distribute out a TIC or fee interest immediately before the closing of the sale of the relinquished property. The TIC or fee interest is distributed to one of the existing partners in redemption for their interest. The distribution takes place typically one or two days before the closing of the sale of the relinquished property. The partner will swap his TIC or fee interest for interest in another property and the other partners may accept cash for their interest so they can exit the real estate partnership.[13]

The FTB has audited taxpayers who have used this structure for their 1031 Drop and Swap exchange. The FTB has argued that this structure is a taxable sale rather than a tax deferred Drop and Swap. The FTB's most effective argument is application of the substance over form doctrine. Under this doctrine, the FTB has argued that the partnership entity rather than the taxpayer was the true seller of the relinquished property. For 1031 to apply, the taxpayer must be both the transferor and the transferee in the transaction. Thus, this doctrine would invalidate the entire tax deferred 1031 transaction. Moreover, the FTB auditors have raised other issues such as the assignment of income doctrine, step transaction doctrine, qualified use and holding period requirements, or underlying timing issues involving the Treas. Reg. 1.1031(k)-1.

SUBSTNACE OVER FORM CASES

The FTB's main argument is that this structure is not valid under the substance over form doctrine. For a valid 1031 Drop and Swap exchange, the taxpayer must be the true seller of the relinquished property and the buyer of the replacement property. Under the substance over form doctrine, the FTB has argued that the partnership or LLC entity was the seller of the relinquished property and not the individual taxpayer. In *Commr. v. Court Holding Co.,* the U.S. Supreme Court held that the Tax Court was justified in attributing the gain from the sale to the corporation, and not the shareholder, because in substance, the corporation was the seller.[14] The U.S. Supreme Court stated:

> A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title.[15]

In *Court Holding Co.,* the shareholder negotiated the sale of the corporation's property on behalf of the corporation in his role as CEO, rather than in their individual capacity as a shareholder. After discovering that the sale would result in significant income tax, the taxpayer immediately distributed the property to himself from the corporation, in kind, as a liquidating distribution. The shareholders then sold the property under the same terms negotiated on behalf of the corporation. The Supreme Court found that the liquidating distribution was a mere formalism, and the true nature of the transaction was a sale by the corporation.[16]

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However, a mere four years after deciding *Court Holding Co.,* the U.S. Supreme Court examined the same issue in *United States v. Cumberland Public Service Co.*[17] In *Cumberland,* the U.S. Supreme Court was again faced with a case in which a corporation liquidated and distributed its assets to the shareholders, who then sold them to the purchaser.[18] In this case, the *Cumberland* shareholders had offered to sell stock, which was countered by the buyer with an offer to purchase assets from the corporation.

The corporation rejected the counteroffer because of the tax cost, and the shareholders then offered to acquire the corporate assets (by a liquidating distribution) and sell them to the buyer. The Supreme Court found this to be perfectly valid and reached a different result than *Court Holding Co*. The Supreme Court held that the sale of the assets formerly held in the corporation was made by the *shareholders* rather than by the corporation.[19] The Supreme Court rejected the government's argument that the shareholders acted as a mere "conduit" for a sale by the corporation.[20] The Supreme Court stated that:

> The Government's argument that the shareholders acted as a mere 'conduit' for a sale by respondent corporation must fall before this finding. The subsidiary finding that a major motive of the shareholders was to reduce taxes does not bar this conclusion. Whatever the motive and however relevant it may be in determining whether the transaction was real or a sham, sales of physical properties by shareholders following a genuine liquidation distribution cannot be attributed to the corporation for tax purposes.[21]

Thus, the Supreme Court upheld legitimate tax planning in advance by the *Cumberland* shareholders, who then acted in their personal capacity in selling the corporation's assets rather than as officers or agents of the corporation. These Supreme Court cases, in addition to the cases described below, serve as guidance for emphasizing who, and in what capacity, negotiates the 1031 exchange.

The legitimacy of such tax planning was further supported by another landmark case, *Bolker*.[22] *Bolker* involved a Southern California real estate developer (Mr. Joseph R. Bolker) who was a shareholder of a corporation (Crosby Corporation) which owned 170 acres of land in Montebello, California.[23] Mr. Bolker conducted his business primarily through numerous corporate entities, which he created to acquire title to the land, to develop the sites either as improvement contractors or building contractors, to sell the finished units, and to maintain the tracts.[24]

None of the real estate development Mr. Bolker engaged in prior to 1972 was carried on in his own name.[25] For approximately three years, the Crosby Corporation tried either to develop or sell the property. During this period, the Southern California Savings & Loan Association agreed to purchase the land, but this deal did not close.[26] Negotiations with the Southern California Savings & Loan Association continued over this period.

At an early stage, the attorneys for Mr. Bolker, who were also the attorneys for the Crosby Corporation, recognized the need to liquidate the corporation, and have Mr. Bolker make the sale in order to save taxes.[27] The tax motivation was not hidden, and was both legitimate and perfectly understandable. Mr. Bolker's attorneys pointed out to the Southern California Savings & Loan Association during the negotiations that even though Crosby Corporation *then* held title to the property, Mr. Bolker individually would be the *ultimate* seller of record.[28]

An agreement was eventually reached for the sale of the property. Crosby Corporation transferred all of its assets and liabilities to Mr. Bolker, who subsequently agreed to an exchange of the property.[29] Three and a half months later, Mr. Bolker received three parcels of real estate, which he had previously designated after the sale and exchange transactions simultaneously closed.[30]

The Tax Court had to determine whether this case fit the mold of *Court Holding Co.* or the more taxpayer-friendly mold of *Cumberland*. Borrowing Justice Douglas' language from *Cumberland,* the Tax Court recognized, just as the U.S. Supreme Court had done, that "the distinction may be particularly shadowy and artificial when the corporation is closely held."[31] The Tax Court weighed the factors established by the Supreme Court in *Court Holding Co.* and *Cumberland*.

Ultimately, the Tax Court found that in substance, the exchange was made by Mr. Bolker, and not by his closely held corporation.[32] One of the essential findings in the Tax Court's decision was that the shareholder negotiated the purchase and sale agreement on his *individual* behalf and not on behalf of his corporation.[33]

The IRS appealed, asserting that Mr. Bolker's exchange of property did not qualify for non-recognition treatment. However, the Ninth Circuit affirmed the Tax Court's decision. The court upheld Section 1031 treatment, noting that Mr. Bolker acquired property with intent to exchange it for like-kind property and held that property for investment. The Ninth Circuit held that a taxpayer can satisfy the 1031 holding and use requirements, even though the taxpayer

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received property with the intent to transfer it as part of a 1031 exchange.

During the same year, the Ninth Circuit Court of Appeals affirmed another similar Tax Court decision. In *Magneson*[34] , the Ninth Circuit Court of Appeals observed that, "[b]etween two equally direct ways of achieving the same result, the Magnesons were free to choose the method which entailed the most tax advantages to them."[35]

In *Magneson,* the Tax Court held that the prearranged transfer of an interest in real property to a partnership following a tax-free exchange satisfied the holding requirement of Section 1031(a). The Tax Court found that the contribution represented a continuation of the old investment, and not a liquidation of that investment, since the transfer to the partnership was not taxable under Section 721. The Tax Court examined the legislative history and intent behind Section 721, which allowed a tax-free contribution of property to a partnership. The Tax Court concluded that inasmuch as the partnership interest was simply the continued holding of the property received in different form, the "holding for investment" requirement of Section 1031 was satisfied. The Tax Court stated:

> The contribution of Plaza Property to U.S. Trust admittedly is a nontaxable transaction under Section 721 which, together with Section 1031, is unequivocally described above in Section 1.1002-1, Income Tax Regs., as representing a continuation of the old investment, not a liquidation.[36]

The Ninth Circuit agreed. Similar to *Bolker,* the Tax Court's clear statement in *Magneson* is that the "holding" issue will be resolved in favor of the taxpayer where acquisition is followed by a tax-free transfer of property to a partnership which continued to hold for investment.

The FTB also routinely relies on another substance over form case, *Delwin Chase v. Commissioner,*[37] and has argued that many Drop and Swap transactions are similar to the transaction in that case. In *Chase,* the Tax Court agreed with the IRS and held that the partnership, JMI, and not the taxpayer Mr. Chase, was the true seller of the relinquished property.[38] After JMI accepted an offer from a buyer of the property, JMI distributed an undivided interest in the relinquished property to the taxpayer Mr. Chase in liquidation of his interest. The taxpayer, in his individual capacity, then proceeded to sell the property to the buyer and entered into a 1031 exchange. The Tax Court applied the substance over form doctrine to recharacterize the exchange as a taxable sale.

Chase involved a taxpayer with many unfavorable facts. Here are just a few:

- The taxpayer in *Chase* never acted or was treated as the owner of an undivided 46.3527% interest in the apartment property.
- The taxpayer concealed the delivery of the deed, held the deed unrecorded for many months, and did not share in the economic income and expenses during his alleged ownership of that interest.
- The taxpayer's 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 apartment property.
- There was no evidence of negotiations by the taxpayers on their own behalf.
- The escrow agreement was not signed by the taxpayers as co-owners.
- The taxpayers did not bear their share of the brokerage commission.
- The partnership agreement prohibited distributions of anything other than cash.

The Tax Court in *Chase* stated:

> Although the general partners of JMI caused JMI to prepare a deed conveying an undivided 46.3527 percent interest in the Apartments to petitioners, at no time did petitioners act as owners except in their roles as partners of JMI. Petitioners were deeded an undivided interest at the time of the first offer because it appeared that a sale was imminent. When this sale failed to close, however, petitioners' deed remained unrecorded until shortly before the disposition in question. There is no indication that any party to the sale believed that anyone other than JMI held title at the time of RWT's offer to purchase. Further, there is no evidence of negotiations by petitioners on behalf of themselves concerning the terms for the disposition of the Apartments. Also, petitioners never paid any of the operating costs of the Apartments or their share of the brokerage commission. Further, petitioners did not receive, or have credited to them, any of the Apartment's rental income.[39]

The Tax Court in *Chase* cited to the *Court Holding Co.* and *Cumberland* decisions for the proposition that, "the substance over form doctrine applies where the form chosen by the parties is a fiction that fails to reflect the economic realities of the transaction." Since these cases have been decided, there have been additional decisions, such as *Appeal of Rago Development,*[40] where the taxpayer prevailed based on the taxpayer's intent and holding period of the TIC interest, and *Appeal of Kwon,*[41] a recent Swap and Drop case involving substance over form, amongst other nonprecedential cases. However, the *Chase, Court Holding Co.,* and *Cumberland* continue to be the main decisions pertaining to Drop and Swap exchanges.[42] The following section describes recent nonprecedential and precedential decisions that have altered the landscape for the FTB and taxpayers engaging in 1031 Drop and Swap exchanges.

NEW CALIFORNIA DROP AND SWAP 1031 DECISIONS

In 2018 the Office of Tax Appeal ("OTA") issued a nonprecedential decision *Appeal of Sharon Mitchell*.[43] This was a major development because this was a rare decision where the taxpayer prevailed and successfully defended her Drop and Swap exchange. The taxpayer, Sharon Mitchell, was a partner in a general partnership ("Con-Med partnership") that owned a building in Walnut Creek, California.[44] The taxpayer wanted to engage in a 1031 exchange of her interest and to continue her investment in real property, while the other partners wanted to cash out.[45] Due to the risk of a delay or dispute about the sale of the property, only the Con-Med partnership negotiated and entered into the sale agreement with the buyer.[46] The Con-Med partnership distributed a TIC interest to the taxpayer and her mother only *one* day before the closing of the exchange. Indeed, the deed creating the TIC interest was not recorded until after the taxpayer had signed the deed transferring the property to the buyer.

Although the purchase and sale agreement in the 1031 Drop and Swap exchange listed the Con-Med partnership as the seller, due to the substance over form analysis in the case, the OTA ruled in favor of the taxpayer that she was the seller of the relinquished property and purchaser of the replacement property. The OTA stated that "the fact that the form of the taxpayer' ownership changed, from owning the property through her general partnership interest to owning it directly, is of no real significance here."[47] The TIC interest was distributed late in the exchange process due to the diverse plans the partners had for the proceeds of their respective investments, rather than due to any intent to avoid tax. The OTA recognized that the buyer was aware from at least the beginning of negotiations that some of the partners of the partnership planned to exchange their partnership shares for TIC interests and then exchange for like kind property.[48] The taxpayer in *Appeal of Sharon Mitchell* had corroborating letters and correspondence that supported this knowledge of the buyer and participants in the exchange.

The FTB historically has argued that the decision of the majority *Sharon Mitchell*[49] should not apply.[50] Shortly after the decision was issued, the FTB petitioned the OTA for a rehearing arguing, among other things, that the OTA erred in applying the law. On January 28, 2020, the OTA issued *another* opinion *denying* the FTB's request for a rehearing.[51] The OTA stated that it did not ignore the *Court Holding Co.* doctrine, but found that the facts in the *Mitchell* transaction were materially distinguishable from *Court Holding Co.*

In the 2020 opinion, the OTA found that the taxpayer in *Sharon Mitchell* met all the requirements for a valid exchange, and did not disguise the transaction by "mere formalisms."[52] The OTA found that the taxpayer did what the taxpayer was required "to navigate the still largely uncharted and obviously treacherous path from owning real property through a partnership interest to direct ownership of a property that successfully results in a valid 1031 exchange."[53] The OTA further held that "the parties engaged in a series of reasonable, necessary, and integrated transactions to accomplish a 1031 exchange. There was no last-minute decision to change the parties at sale."[54]

In 2022, the OTA issued a precedential decision *Appeal of FAR Investments Inc. and Arciero & Sons Inc.*[55] This has significance because the OTA will generally rule in adherence on future cases if they have similar facts. In this decision, the taxpayers, through their ownership in Arciero Wine Group ("AWG"), owned a winery in Paso Robles, California as well as equipment, buildings, offices, gift shops, and land. AWG sold the winery and equipment to an unrelated buyer in 2007. The taxpayers entered into a 1031 Drop and Swap exchange, while the other owner of AWG, Young's Holding Inc. ("YH") cashed out with the proceeds from the sale. The taxpayers received a TIC interest a few days before the sale closed and recorded the TIC interest on the day of the sale.

The asset purchase agreement listed the AWG entity as the seller as opposed to the taxpayers. Several days after the asset purchase agreement was executed, AWG signed over the deed to the property to the taxpayers through distributing TIC interests, and the taxpayers then transferred their TIC interests to the buyer. The taxpayers argued that a bifurcated sale took place, one involving AWG's inventory and equipment and the winery, and that the winery sale was made by AWG's owners (the taxpayers) and not AWG.

The taxpayers stated that at all times, in the negotiation, the parties involved knew that a 1031 exchange would be consummated with the owners of AWG. The OTA ruled in favor of the FTB that AWG were the sellers of the winery as opposed to the taxpayers. AWG also paid the operating expenses of the winery including utility expenses, property maintenance expenses, and insurance expenses until the sale closed. The property taxes and mortgage interest were paid

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out of the sale proceeds and not by the taxpayers. There was also no evidence that the taxpayers acted as the owners or held themselves out as the owners of the winery after the deed was conveyed to them by AWG.

For example, the record in *Appeal of F.A.R. Investments Inc. and Arciero & Sons Inc.* demonstrated that it was AWG and not the taxpayers that negotiated the terms of the sale. The record also showed that the taxpayer's *only* involvement in the sale was implementing the 1031 exchange, rather than the terms of the sale.

Taxpayers in California should pay attention to the *Appeal of F.A.R. Investments Inc. and Arciero & Sons Inc.* decision since it could negate the usefulness of the *Sharon Mitchell* decision. It is imperative then that taxpayers take proactive steps to sufficiently distinguish their Drop and Swap exchange from these cases.

PREVENTIVE MEASURES TAXPAYERS CAN ADOPT FOR DROP AND SWAP EXCHANGES

For taxpayers that are contemplating a 1031 Drop and Swap exchange in California, it would be prudent to adopt the following steps to minimize the chance of an audit. Based on existing caselaw, the first step should be to distribute the TIC interest from the entity to the taxpayer several months, or more, in advance of the sale of the property.[56] The TIC interest, after the distribution, should be recorded as soon as possible. Ideally the TIC interest would be distributed to the individual taxpayer before negotiations for the sale of the property begin.

The taxpayer can then report the income or property expenses for their period of ownership on their individual tax returns, which would be on Schedule E of their Form 1040. This would also help demonstrate that the taxpayer bears the economic benefit and risk of the property for an extended period of time. In the cases discussed in Part II, none of the taxpayers were able to distribute the TIC interest in advance of the sale. Thus, following this step could help either avoid or successfully defend the Drop and Swap exchange in an FTB audit. It is crucial that the taxpayers conduct as many actions as possible to demonstrate their true ownership of the property in this time period.

One deterring factor is that an early distribution of a TIC interest, especially several months or a year before a sale, is not always practical. This could result in a default of existing loan agreements for the property or violation of other contractual matters. Loan documents normally contain restrictions concerning the moving of title to the property before the loan is paid off. An early distribution of a TIC interest should be examined on a case-by-case basis, but there are other steps taxpayers can follow to help defend their Drop and Swap exchange.

Taxpayers that are contemplating a Drop and Swap exchange in California should demonstrate they have carried the burden and benefits of ownership. This would help support the notion that the Taxpayers owned the property, at least temporarily, before relinquishing it. The seminal case in this area is *Grodt & McKay*.[57] In this case, the Tax Court listed several factors which would determine whether the benefits and burdens of ownership have passed from the transferor to the transferee. These factors are (i) whether legal title passes; (ii) how the parties treat the transaction; (iii) whether equity is acquired in the property; (iv) whether the contract creates a present obligation on the seller to execute and deliver the deed and a present obligation on the purchaser to make payments; (v) whether right of possession is vested in the purchaser; (vi) which party pays the property tax; (vii) which party bears risk of loss or damage to the property; and (viii) which party receives profits from the operation and sale of the property.[58]

Taxpayers will need to take several actions to satisfy the above factors rather than solely relying on intentions since the OTA will not be persuaded by this. Taxpayers should pay property taxes through their personal funds and accounts, pay operating expenses in their individual capacity and not through the entity, receive income from the property to their personal bank account, and write correspondence from their personal email address and letterhead. It could also help if they can enter into an agreement with the partnership to be liable for expenses and to carry out the above actions in their individual capacity, and not as the managing member of the LLC or partnership entity.

The taxpayers should also amend the purchase and sale agreement to list the individual taxpayer as the seller of the relinquished property. However, as described earlier, this could be difficult to implement in practice since it may result in breaching existing loan agreements and the property being in default of any outstanding loans or mortgages. Other unwanted consequences from this action could be the loss of liability protection, lender liens being disrupted, impact on record title, loss of existing control structures, and significant risk to prematurely ending the sale.

It is crucial for the Drop and Swap that the taxpayers participate in the negotiation of the sale, and not through a partnership. This helps demonstrate that they personally negotiated the terms of the sale. This can get confusing because many times the one negotiating the sale is the taxpayer, who is also the managing member of the partnership, since many investors own property through small partnerships.[59] However, it is crucial that the taxpayers

participate in the negotiation in their individual capacity. For example, if the terms of the sale, following the distribution of the TIC interest, are different than the negotiations between the partnership and the buyer before the distribution, then the substance-over-form doctrine may not be applicable.[60]

The taxpayer in *Sharon Mitchell* was able to demonstrate that it was known to all parties throughout the negotiation that a 1031 exchange would be consummated and that she was one of the individual owners of the property. Sharon's mother, who also had a TIC interest, attended the meetings with the buyer to negotiate the sale of the property. There was also a redemption agreement by the Con-Med partnership which was acknowledged and signed off by the buyer of the property, documenting their understanding that Sharon would be one of the individual owners of the property through her TIC interest. Furthermore, the closing date was extended for 60 days to accommodate the 1031 exchange and the distribution of the TIC interest to Sharon and her mother. The counter offers during the negotiation included language to extend the closing date to carry out the 1031 exchange.[61]

Taxpayers should document any terms or conditions of the sale that were of concern to the individual taxpayer as the owner of the property. Listing the taxpayer as the seller on a listing agreement could help as well as including the taxpayer on the escrow documents, loan payoff statement, and other relevant documents to the sale. It should be clear to any buyer who is interested in purchasing the property that the seller is the partnership and the individual who is departing the partnership.

ALTERNATIVE STRUCTURES

In many property transactions, by the time people realize the need for a Drop and Swap, the partnership has been involved extensively in the negotiation phase, which raises many tax risks for the Drop and Swap. If California taxpayers cannot implement the above steps for their Drop and Swap exchange, it may be feasible to try other types of exchanges or transactions, where it is permissible for the partnership to be the negotiator. One common alternative to a Drop and

Swap exchange, is the use of a Delaware Statutory Trust ("DST"). In this structure, the taxpayers would own beneficial interests ("BI") in a DST with a multi-beneficiary grantor trust status.[62] The use of DSTs in 1031 exchanges was approved by the IRS in Revenue Ruling 2004-86.[63] Real estate partnerships could choose to convert to a DST and then proceed to sell the property. Through this structure, the BI holders can either swap their BI's for other interests in real property or receive cash and exit their real estate holding.

For those thinking of using a DST due to the tax risks for a Drop and Swap, it's important that the DST trustee adhere to the restrictions in the Revenue Ruling 2004-86 in order to maintain the DST status.[64] Due to these restrictions, the DST structure would be ideal for those that are passive owners of real estate, rather than those that own and conduct a business through their real estate holdings. The DST would effectively maintain several benefits that a traditional Drop and Swap exchange would not have. These benefits consist of liability protection built in, existing lender liens remaining intact, reduced impact on record title since a deed does not need to be recorded, and no contract assignment needed since the DST can remain as the entity in the contract to sell the property.

Another alternative would be for the partnership to enter into a 1031 exchange with an installment note distributed to the exiting partner. Through this structure, the partner that wishes to cash out and exit his real estate holding, can receive the installment note from the partnership in complete liquidation of his interest in the partnership. The partner would not recognize gain upon the distribution of the installment note but takes basis in the note equal to his former outside basis in the partnership.[65] Taxpayers may also use a qualified intermediary to facilitate a deferred exchange.

Similar to 1031 Drop and Swap, this structure involving an installment note faces many practical considerations. Potential buyers of the relinquished property may not find it appealing to issue an installment note. Those that are interested or are ok with issuing an installment note could negotiate for more exacting terms during the negotiation of the sale of the property. There are also credit concerns regarding the installment note which the exiting partner may not prefer. Last, this structure, while avoiding the substance over form issues, may lead to additional audit issues for the exiting partner who receives the installment note. For example, if the note is issued by the intermediary, it may run afoul of the safe harbor in the Treasury regulations for the qualified intermediary. This could happen if the intermediary pays the exiting partner the amount due on the note from the sale proceeds before the time when the partnership is entitled to receive the funds under Section 1031. The partnership may have obtained the benefit of the exchange funds in violation of the safe harbor.[66]

The last alternative[67] for an exchange is a partnership division under IRC Section 708. The Tax Cuts and Jobs Act made significant revisions to this section by eliminating the technical termination rules. This structure can help because each of the resulting partnerships can be treated as continuing partnership of the original partnership entity. Thus, there is an argument that each is still the same partnership as the one which negotiated the sale prior to the division.[68]

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In this structure, the partnership could transfer the relinquished property in a 1031 exchange and then divide. Each of the partnerships surviving the division is a resulting partnership.[69] One of the resulting partnerships acquires replacement property and completes the exchange. The other resulting partnerships do not. Similar to the other alternatives discussed in this section, there are practical concerns, and a buyer or the other partners may not be ok with this structure. For example, this structure could violate special purpose entity restrictions and covenants.

CONCLUSION

While California has taken an aggressive approach towards Drop and Swap exchanges, it is still a viable transaction taxpayers can undertake to achieve their business and financial goals. Due to the recent precedential cases in favor of the FTB, taxpayers who will use a Drop and Swap exchange should try to implement some of the suggestions in this article, including distributing a TIC interest in advance of the sale. Although there are pros and cons with each of the suggestions, it would be to the benefit of taxpayers in California to not distribute the TIC interest on the day of closing or immediately before the closing of the sale. Taxpayers must plan these transactions carefully as they present significant audit and tax risk in California.

Notes:

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2. In December of 2017, Congress enacted Public Law 115-97 (*See* Pub. L. No. 115-97, § 13303, 131 Stat 2054 (2017)), which modified Section 1031 to apply only to exchanges of real property, effective for exchanges completed after December 31, 2017. However, this change does not impact this analysis due to both the tax year at issue and the transaction involving real property.

3. IRC § 1031(a)(1) and (2).

4. Although the IRS has interpreted the "like-kind" requirement broadly, the IRS interpreted this much more narrowly for non-real estate property.

5. California imposes a clawback provision where nonresidents who exchange California property for non-California property must file annual returns. Failure to file will result in immediate tax on the gain. Cal. Rev. & Tax Code § 18032 and 24953. *See* Form FTB 3840. California applies § 1031 more broadly for individuals with adjusted gross income below specified thresholds (Cal. Rev. & Tax Code § 18031.5).

6. IRC § 1031(a)(3)(A) and Treas. Reg. § 1.1031(k)-1.

7. IRC § 1031(a)(3)(B) and Treas. Reg. § 1.1031(k)-1; Note that reverse exchanges are also possible.

8. IRC § 1031(a). The Taxpayer must hold the property for productive use in a trade or business or for investment.

9. *Bergford v. C.I.R.* 12 F.3d. 166 (9th Cir. 1993). *Madison Gas & Electric Company v. Commissioner* 633 F.2d 512 (7th Cir. 1980), *aff'g* 72 TC 521 (1979).

10. Rev. Proc. 2002-22 2002-14 I.R.B. 733.

11. Although TICs remain common, DSTs are now used more for real property to exchange into (since they can better handle more business contingencies and be run as a single entity for certain purposes).

12. California Franchise Tax Board Notice 2000 1107 02.

13. The Partner might also accept the TIC and sell it themselves.

14. *Commissioner. v. Court Holding Co.,* 324 US 331 (1945) (Note that this case was decided when corporate liquidations could be tax-free (*General Utilities*)—same for *Cumberland* and *Bolker*).

15. *Commissioner v. Court Holding Co.,* 324 US 331, 333 (1945).

16. *Commissioner v. Court Holding Co.,* 324 US 331, 333 (1945).

17. *United States v. Cumberland Public Service Co.,* 338 US 451 (1949).

18. *United States v. Cumberland Public Service Co.,* 338 US 451, 452 (1949).

19. *United States v. Cumberland Public Service Co.,* 338 US 451, 455-56 (1949).

20. *United States v. Cumberland Public Service Co.,* 338 US 451, 455 (1949).

21. *United States v. Cumberland Public Service Co.,* 338 US 451, 455 (1949).

22. *Bolker v. Commissioner,* 760 F2d 1039 (9th Cir. 1985), aff'g. 81 TC 782 (1983).

23. *Bolker v. Commissioner,* 81 T.C. 782, 784 (1983).

24. *Bolker v. Commissioner,* 81 T.C. 782, 784 (1983).

25. *Bolker v. Commissioner,* 81 T.C. 782, 784 (1983).

26. *Bolker v. Commissioner,* 81 T.C. 782, 801-03 (1983).

27. *Bolker v. Commissioner,* 81 T.C. 782, 801-03 (1983).

28. *Bolker v. Commissioner,* 81 T.C. 782, 801-03 (1983).

29. *Bolker v. Commissioner,* 81 T.C. 782, 791 (1983).

30. *Bolker v. Commissioner,* 81 T.C. 782, 793 (1983).

31. *Bolker v. Commissioner,* 81 T.C. 782, 798 (1983).

32. *Bolker v. Commissioner,* 81 T.C. 782, 801-02 (1983).

33. *Bolker v. Commissioner,* 81 T.C. 782, 801-03 (1983).

34. *Magneson v. Commissioner,* (9th Circ. 1985) 753 F.2d 1490.

35. *Magneson v. Commissioner,* (9th Circ. 1985) 753 F.2d 1490,1497.

36. *Magneson v. Commissioner,* 81 T.C. 767, 771.

37. *Delwin Chase v. Commissioner,* 92 TC 874 (1989).

38. *Delwin Chase v. Commissioner,* 92 TC 874 (1989).

39. *Delwin Chase v. Commissioner,* 92 TC 874, 881-82 (1989).

40. *Appeal of Rago Development Corp. et al.,* (2015-SBE-001) (Taxpayer victory based partially on holding period of his TIC interest).

41. *Appeals of Kwon, et al.,* 2021-OTA-296P (Swap and Drop).

42. *See Mason v. Commissioner,* T.C. Memo. 1988-273; *Marks v. Department of Revenue,* Oregon Tax Court No. TC-MD 050715D (2007); *Consolidated Appeal of S.Kwon et al.* OTA Case Nos. 18011810, 18011811, 18011812, and 118011813 (April 14, 2021); *Appeal of Brookfield Manor,* Inc., et al., (89-SBE-002); *Appeal of Rago Development Corp. et al.,* (2015-SBE-001).

43. *Appeal of Sharon Mitchell,* 2018-OTA-210 (Aug. 2, 2018).

44. *Appeal of Sharon Mitchell,* pg. 1, 2018-OTA-210 (Aug. 2, 2018).

45. *Appeal of Sharon Mitchell,* pg. 1, 2018-OTA-210 (Aug. 2, 2018).

46. *Appeal of Sharon Mitchell,* pg. 14, 2018-OTA-210 (Aug. 2, 2018).

47. *Appeal of Sharon Mitchell,* pg. 5, 2018-OTA-210 (Aug. 2, 2018).

48. *Appeal of Sharon Mitchell,* pg. 2, 2018-OTA-210 (Aug. 2, 2018).

49. *Appeal of Sharon Mitchell,* 2018-OTA-210 (Aug. 2, 2018).

50. *See* Chief Counsel Corner August 2020 Tax news, available at https://www.ftb.ca.gov/about-ftb/newsroom/tax-news/august-2020/chief-counsel-corner.html.

51. *In the Matter of the Appeal of Sharon Mitchell* (OTA Case No. 18011715, January 28, 2020).

52. *In the Matter of the Appeal of Sharon Mitchell* (OTA Case No. 18011715, January 28, 2020), pg. 10.

53. *In the Matter of the Appeal of Sharon Mitchell* (OTA Case No. 18011715, January 28, 2020), pg. 10.

54. *In the Matter of the Appeal of Sharon Mitchell* (OTA Case No. 18011715, January 28, 2020), pg. 10.

55. *Appeal of FAR Investments Inc. and Arciero & Sons Inc.* 2022-OTA-395P.

56. Note that in F.A.R. OTA references Chase, and arguably indicates that length of ownership is not a major factor so long as during the ownership window the distributee partners really act like owners. Practically, of course, the earlier you can make the distribution, the better it is.

57. *Grodt & McKay Realty, Inc. v. Commissioner,* 77 T.C. 1221 (1981).

58. *Grodt & McKay Realty, Inc. v. Commissioner,* 77 T.C. 1221 (1981).

59. *See Bolker v. Commissioner,* 81 T.C. 782, 803 (1983) (Discussing the confusion of who is negotiating the sale).

60. *Commissioner v. Court Holding* at 332-33; *Hiens v. US,* 477 F.2d 1063, 1070 (substance-over-form not applicable where subsequent sale was the result of independent and active negotiations).

61. *Appeal of Sharon Mitchell,* pgs. 3-4, 2018-OTA-210 (Aug. 2, 2018).

62. Grantor Retained Trust is a disregarded entity and thus the sale, if attributable to the DST, is arguably treated as if done directly by the owners.

63. Revenue Ruling 2004-86, 2004-33 I.R.B. 191 (holding that beneficial interest in a DST are qualifying replacement property).

64. Trustee cannot have the power to: (1) dispose of DST property and then acquire new property (2) enter into new leases (3) renegotiate a lease with an existing tenant unless the tenant is insolvent or bankrupt (4) renegotiate the debt used to acquire the property (5) refinance the debt used to acquire the property (6) invest cash received from the property to profit form market fluctuations (7) make more than minor non-structural modifications to the property

65. Note the many restrictions with installment sales, certain related persons, and potential depreciation recapture. *See* Treas. Reg. § 15a.453-1 and IRC § 453.

66. Treas. Reg. § 1.1031(k)-1.

67. There is also another alternative to dropping and swapping, where the partnership will specially allocate the 1031 gain to one partner and the recognized gain to another. In practice, there are too many downsides for this to really be selected.

68. *See* Private Letter Ruling 200921009, May 22, 2009,

69. IRC § 708; Treas. Reg. § 1.708-1.