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How 1031 Exchanges Work, Including Controversial Drop & Swap Exchanges

By Robert W. Wood

A 1031 exchange is a swap of one business or investment asset for another. Although most swaps are taxable as sales, including swaps of one type of crypto for another such as Bitcoin for Ethereum. But if you come within section 1031 of the tax code, you'll either have no tax or limited tax due at the time of the exchange. 1031 used to work for businesses, crypto, airplanes, artworks, and so on, but since 2018, the provision only applies to real estate.

In effect, you can change the form of your investment without (as the IRS sees it) cashing out or recognizing a capital gain. That allows your investment to continue to grow tax deferred. There's no limit on how many times or how frequently you can do a 1031. You can roll over the gain from one piece of investment real estate to another to another, and another. Although you may have a profit on each swap, you avoid tax until you actually sell for cash many years later. Then you'll hopefully pay only one tax, and that at a long-term capital gain rate.

Special rules apply when depreciable property is exchanged in a 1031. It can trigger depreciation recapture that is taxed as ordinary income. In general, if you swap one building for another building, you can avoid this recapture. But if you exchange improved land with a building for unimproved land without a building, the depreciation you've previously claimed on the building will be recaptured as ordinary income.

The provision is only for investment and business property, so you can't swap your primary residence for another home. There are ways you can use a 1031 for swapping vacation homes, but this loophole is much narrower than it used to be.

Most exchanges must merely be of "like-kind"--an enigmatic phrase that doesn't mean what you think it means. You can exchange an apartment building for raw land, or a ranch for a strip mall. The rules are surprisingly liberal.

Classically, an exchange involves a simple swap of one property for another between two people. But the odds of finding someone with the exact property you want, who wants the exact property you have, are slim. For that reason, the vast majority of exchanges are delayed, three party, or “Starker” exchanges (named for the first tax case that allowed them). In a delayed exchange, you need a middleman who holds the cash after you "sell" your property, who then uses it to "buy" the replacement property for you. This three-party exchange is treated as a swap.

You must designate replacement property. There are two key timing rules you must observe in a delayed exchange. The first relates to the designation of replacement property. Once the sale of your property occurs, the intermediary will receive the cash. You can't receive the cash, or it will spoil the 1031 treatment. Also, within 45 days of the sale of your property you must designate replacement property in writing to the intermediary, specifying the property you want to acquire.

You can designate multiple replacement properties. There's long been debate about how many properties you can designate and what conditions you can impose. The IRS says you can designate three properties as the designated replacement property so long as you eventually close on one of them. Alternatively, you can designate more properties if you come within certain valuation tests.

You must close within six months. The second timing rule in a delayed exchange relates to closing. You must close on the new property within 180 days of the sale of the old. Note that the two time periods run concurrently. That means you start counting when the sale of your property closes. If you designate replacement property exactly 45 days later, you'll have 135 days left to close on the replacement property.

If you receive cash, it's taxed. You may have cash left over after the intermediary acquires the replacement property. If so, the intermediary will pay it to you at the end of the 180 days. That cash--known as "boot"--will be taxed as partial sales proceeds from the sale of your property, generally as a capital gain.

Consider mortgages and other debt. One of the main ways people get into trouble with these transactions is failing to consider loans. You must consider mortgage loans or other debt on the property you relinquish, and any debt on the replacement property. If you don't receive cash back but your liability goes down, that too will be treated as income to you, just like cash. Suppose you had a mortgage of $1 million on the old property, but your mortgage on the new property you receive in exchange is only $900,000. You have $100,000 of gain that is also classified as "boot," and it will be taxed.

How About Partnerships? You cannot exchange partnership interests, but partnerships can exchange properties, so the partners benefit. But what if some partners want to cash out and some want to exchange? Enter the drop and swap. A Drop & Swap may involve the partnership or LLC dropping (distributing) the title of the relinquished property to the member/partners as Tenants in Common (TICs). Then, the individual tenants in common can make their own decisions to *swap* in a like kind exchange.

The IRS doesn’t especially like these, but they *can* work with the right facts and timing. The FTB likes them even less, but again, they *can* work. A key variable is how long a gap in time exists between these elements, and if the IRS or the FTB thinks that wait was long enough. The IRS and the FTB look for whether the relinquished property and the replacement property were held for a sufficient time period to be considered an actual *investment*. The IRS and the FTB also ask whether the ownership structure was created solely to avoid paying tax on the gain.

There are several California cases on point. In *Appeal of Pau*, petition for rehearing denied, 2019-OTA-119; *Appeal of Pau* (December 17, 2017), Call. St. Bd. of Equal., Case No. 959931, an individual partner of a tiered entity partnership role exchanged his partnership interest for a tenancy in common interest (TIC) to the buyer *just* prior to selling the

relinquished property. This “drop” left Pau, as the sole partner and owner, while the other partner’s partnership interests were exchanged as TIC percentage interests. Pau then purchased replacement property within an LLC, claiming it was a single member LLC and attempted to defer his capital gains.

Pau’s 1031 exchanged failed for several reasons. First, the partnership negotiated the sale, signed the purchase and sale agreement, made no indications of the plan to convert to TICs prior to the sale, and held the burdens of ownership of the relinquished property up until the very end. It also appeared that the last-minute change in ownership structure was designed to avoid paying tax on the sale.

Plus, the length of time the other partners had been TICs did not suggest investment intent, and Pau’s sole partnership was rolled into the replacement property purchasing LLC. What’s more, the purchase of the replacement property was not in Pau’s single member LLC; there were 3 members. Finally, the previous TICs from the sale of relinquished property cashed out and did not reinvest in the replacement property.

In 2022, the OTA issued a precedential decision, *Appeal of FAR Investments Inc. and Arciero & Sons Inc*. 2022-OTA-395P. The precedential decision is significant 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, CA 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 while the other owner of AWG 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. When selected for audit, 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, and thus this was a taxable sale and not a Drop and Swap. In the record, it was demonstrated that AWG, and not the taxpayers, paid the operating expenses of the winery including the utility expenses, property maintenance expense, and insurance expense until the sale closed. The property tax and mortgage interest were paid 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.

However, in a nonprecedential decision *Appeal of Mitchell*, *Appeal of Mitchell*, 2018-OTA-210, petition for rehearing denied, 2020-OTA-001 the OTA found a valid tax deferred exchange with a Drop & Swap. The relinquished property was held by a partnership, and days prior to closing, two partnership interests were moved into TICs. However, all parties knew ahead of time of the ownership interest changes, and the exchange was valid because it was performed by the 3 separate taxpayers (the partnership and the two transferred TICs).

None of the parties cashed out, and the 3 taxpayers purchased the replacement property together. There were no structure/entity surprises, and the tax deferred exchange was upheld. The OTA noted that there is no time requirement for length of ownership (many people rely on the two-year safe harbor). The OTA said the full substance of ownership was relevant.

Mitchell shows that a Drop & Swap *can* be successful if it is well documented and disclosed from the start. Ideally, no parties will cash out, and all will remain in the exchange. *Pau* and *FAR Investments* show that last-minute ownership changes, with parties cashing out and failing to reinvest in new replacement property, may be fatal. Be careful out there!

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