Swap New Year's Resolutions for Real Property with a 1031 Tax-Deferred Exchange

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A 1031 Tax-Deferred Exchange ("***§ 1031 Exchange***") is an extremely useful tax strategy for taxpayers that maintain real property for productive use in trade, business or for investment. It allows a taxpayer to defer payment of capital gains tax on investment properties that are sold.

A taxpayer continues to qualify for a § 1031 Exchange if the following rules are met: (1) the properties being exchanged must be "like-kind"; (2) the taxpayer must transfer property held for productive use in a trade, business or for investment (the "***Relinquished Property***") and subsequently receives property to be held either for productive use in a trade, business or for investment (the "***Replacement Property***")"; (3) the Replacement Property value must be greater than or equal to the Relinquished Property value; (4) the taxpayer must not receive "boot" in order for the exchange to remain tax-free; (5) the name on title of the Relinquished Property must mirror the name on the title of the Replacement Property; (6) the taxpayer must identify a replacement property within 45 days after the taxpayer transfers the Relinquished Property; and (7) the taxpayer must receive the Replacement Property within 180 days of the transfer of the Relinquished Property, or on the date the taxpayer's tax return is due, whichever is earlier.

Section 1031 Exchanges, while an excellent tax deferral tool, are not without complications. Section 1031 Exchanges must be used exclusively for the exchange of real property held for investment or business purposes. Section 1031 Exchange rules also require the title of the Replacement Property to be under the same name as the title of the Relinquished Property. Any real property interests owned by a limited liability company or a partnership must be reinvested by the entity in real property of "like-kind" nature for investment or business purposes in order for it to qualify under § 1031. This is a problem if an individual member or partner of the entity wishes to "cash out" or reinvest in something other than "like-kind" real property. To remedy this problem, many transactions are structured as a "drop and swap" where the interests in the real property are transferred to the individuals as tenants in common and those tenants in common, as individuals, deed the Relinquished Property to the buyer. Because the taxpayers, as individuals, sold the Relinquished Property, it is the individuals that must reinvest in the Replacement Property to utilize the tax

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deferrals under § 1031. Because the individuals are tenants in common, each is able to choose independently whether to reinvest in a Replacement Property and defer tax under § 1031 or cash out and pay the tax on their individual earnings from the sale of the property.

However, this "drop and swap" technique is increasingly disfavored by the IRS and may create tax implications for the taxpayers if the real property is acquired by the individual taxpayers immediately prior to the sale. Since real property must be for investment or business purposes to be eligible under a § 1031 Exchange, it is best practice to distribute the interests in the property to the individuals well in advance of the date of the relinquishment so each individual holds the property long enough to constitute an investment. While the IRS has not provided guidelines on the length of the holding period, it is recommended that such transfer, or "drop" to the individuals occur at least a year in advance before the closing on the Relinquished Property and that records be kept of the transfer and the intent of the taxpayers to hold the real property for business or investment. Moreover, taxpayers need to take care when transferring ("dropping") the interest in the real property from the entity to individual tenancy-in-common interests to ensure the taxpayers aren't viewed as operating as a partnership and thus, subject to ownership constraints of a partnership (this would likely negate the drop and swap technique and require the individuals, as tenants-in-common but operating as a partnership, to all invest in the Replacement Property for some to benefit from tax deferral under a §1031 Exchange).

There does not appear to be any limitation on how an individual taxpayer uses their proceeds if they are cashing out, and have no intent to defer tax under a § 1031 Exchange. However, for a taxpayer to defer tax under a § 1031 Exchange the above requirements must be met, and there can be no actual or constructive receipt of money or other property before the taxpayer actually receives the Replacement Property. Even if the taxpayer may ultimately receive the like-kind Replacement Property, any receipt of cash or other property, including an interest in an additional entity or personal property, prior to that Replacement Property will make the transaction a sale rather than a deferred exchange and prevent the taxpayer from gaining the tax deferral under a § 1031 Exchange.