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California State Appellate Board Approves 1031 Exchange "Swap and Drop"

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Section 1031 of the Internal Revenue Code enables taxpayers to make a tax-free exchange of real property ("relinquished property") for other real property ("replacement property"). In order for a transaction to qualify as a tax-free like-kind exchange under section 1031, both the relinquished property and the replacement property must be held for productive use in a trade or business or held for investment (the "holding requirement"). Partnership interests do not qualify as either relinquished property or replacement property for a 1031 exchange.

Replacement property will fail to satisfy the holding requirement if it is sold soon after it is acquired, since the holding requirement would not be satisfied. However, neither the Internal Revenue Code nor the Treasury Regulations addresses whether a tax-free contribution to a partnership, or a tax-free distribution by a partnership to its partners, can cause the holding requirement to not be satisfied. One common scenario where this issue comes up is when partners want to cause a partnership to acquire multiple replacement properties and then distribute separate replacement properties out to different partners that want to go their separate ways. Another common scenario is where a taxpayer wants to contribute its replacement property to a partnership shortly after a 1031 exchange. These like-kind exchanges are commonly referred to as "swap and drop" exchanges.

There seems to be a strong argument that a taxpayer should be considered to "hold" relinquished property or replacement property that is owned through a partnership for purposes of determining whether the holding requirement is satisfied. While there is limited authority related to this issue, several relevant cases have been decided in favor of taxpayers.[1] However, the IRS has taken the position that these like-kind exchanges can fail to qualify under section 1031 as a result of the post-exchange partnership contribution or distribution causing the replacement property to not meet the holding requirement. In any specific case, the IRS view of the transaction would likely depend on various factors including (i) the amount of time that elapses between the like-kind exchange and the partnership contribution or distribution and (ii) the point at which a binding contract is entered into for the latter transfer.

While the IRS may be auditing only a small fraction of like-kind exchanges, we have seen New York State begin to audit like-kind exchanges with an increased frequency, taking aggressive positions in challenging "swap and drop" exchanges. With this backdrop, New York taxpayers will be interested to see a favorable recent decision of the California State Board of Equalization.

"Rago Development"

The *Appeals of Rago Development Corporation, et al.*[2] involved a transaction where the taxpayers acquired tenancy-in-common ("TIC") interests in real property as replacement property for 1031 exchanges on June 30, 2003. Prior to that date, the taxpayers had entered into a loan agreement with a lender pursuant to which the taxpayers would be required to contribute their TIC interests to a single purpose LLC (the "LLC") no later than January 31, 2004. The taxpayers subsequently contributed their TIC interests to the LLC on January 31, 2004.

The California Franchise Tax Board (the "FTB") asserted that the contribution of the replacement property to the LLC caused the holding requirement to not be satisfied for the replacement property. The FTB also made a separate argument that, under the step transaction doctrine, the taxpayers should be treated as if they had exchanged their relinquished property for interests in the LLC (which would not constitute qualifying replacement property for a 1031 exchange). After protest hearings, the FTB issued Notices of Action determining that the taxpayers recognized additional gain as a result of the transactions not qualifying as 1031 exchanges. The taxpayers then appealed to the California

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State Board of Equalization (the "BOE").

With respect to the holding requirement, the BOE analyzed Federal income tax authority and explained that the courts examine the intent of taxpayers at the beginning of the exchange to determine whether there is an intent to hold the replacement property for investment or for use in a trade or business. The BOE stated that courts "find that the holding requirement can be met when there remains an economic interest in essentially the same investment, despite a change in the form of ownership" and that "a prearranged plan to transfer property to a different form of holding is not sufficient, by itself, to disqualify a claimed IRC section 1031 like-kind exchange where the taxpayer continues to maintain his or her investment in the property." Thus, the BOE understood the relevant authority to provide that a taxpayer is considered to continue to "hold" real property that is contributed to a partnership for purposes of determining whether the holding requirement is satisfied.

In the taxpayers' case, the BOE held that (i) the taxpayers acquired the replacement property with the intent to hold it as investment or for use in their trade or business and (ii) the contribution of the replacement property to the LLC "did not significantly alter [the taxpayers'] continued economic investment in the property." Therefore, the BOE concluded that the holding requirement was satisfied.

The BOE then considered the FTB's alternative contention that, under the step transaction doctrine, the taxpayers should be treated as having exchanged their relinquished property for the LLC interests that they ended up owning. As noted above, the specific facts in this case involved the taxpayers having entered into a loan agreement prior to their acquisition of the TIC interests that required the taxpayers to contribute the TIC interests to the LLC within seven months. Still, the BOE concluded that the taxpayers' transaction steps should not be recharacterized under the step transaction doctrine, explaining that "[o]n the record before us, the acquisition of the replacement property as tenants in common is the type of business activity we would expect to see in a bona fide, arm's length business deal between unrelated parties, and makes sense standing alone without contemplation of the subsequent transfer to an LLC." The BOE focused on the fact that, during the seven month period when the taxpayers owned the TIC interests, they "bore the economic risks of value depreciation and physical damage, and also held the benefit of any increase in value." Accordingly, the BOE rejected all of the FTB's arguments and determined that the taxpayers had conducted valid 1031 exchanges.

Conclusion

While the BOE's step transaction analysis is interesting, its more important holding is the determination that the holding requirement can be satisfied with respect to replacement property that is contributed to a partnership. Of course, this California decision has no direct impact on New York taxpayers, and the facts considered were specific to the transaction in question. However, the decision nonetheless is significant in that it constitutes an impartial determination that a type of "swap and drop" like-kind exchange qualified under section 1031. While it remains to be seen what happens to case law and IRS and New York State audit practice in this area, this decision by the California BOE is good news for taxpayers in California as well as in other states.

[1] See *Magneson v. Commissioner*, 753 F.2d 1490 (9th Cir. 1985); *Bolker v. Commissioner*, 760 F.2d 1039 (9th Cir. 1985); *Maloney v. Commissioner*, 93 T.C. 89 (1989).

[2] Case No. 735761, June 23, 2015.