To Have and Hold for Investment Under §1031

An Analysis of the *Oregon Department of Revenue v. Marks* (2009)

1031 Knowledge

Internal Revenue Code Section 1031(a)(1) provides that "[n]o gain or loss shall be recognized on the exchange of real property *held for productive use in a trade or business or for investment* if such real property is exchanged solely for real property of like-kind *to be held either for use in a trade or business or for investment.*" The requirement that both the real property relinquished in a 1031 exchange and the replacement property received be held for use in a trade or business or for investment, often referred to as the "holding requirement," has been the subject of significant litigation between the IRS, state tax authorities, and taxpayers over the years.

One area of significant litigation between taxpayers and tax authorities involves 1031 exchanges in which a selling taxpayer changes the manner in which the relinquished property has been owned immediately prior to a sale, or changes the form of ownership of the replacement property soon after the 1031 exchange has been completed. To the extent that the change in the form of ownership is viewed by tax authorities as a transfer of the property to another person or legal entity, the taxpayer may be treated as having not satisfied the holding requirement.

In a typical case, the taxpayer is a partner in a partnership or a member in a limited liability company that owns investment property that would qualify for a tax-deferred exchange under Section 1031(a), but the partner wants to engage in a 1031 exchange separate from the partnership. Alternatively, the taxpayer may own investment property in fee or with others as tenant-in-common, but desires to contribute the replacement property to a limited liability company or partnership in which the taxpayer would be a member or partner following the completion of the exchange. Unfortunately, the taxpayer's ownership interest in the investment property (either before the exchange or following its completion) is held in the form of a partnership interest or membership interest (treated as a partnership interest under federal tax law). In either such case, Internal Revenue Code Section 1031(a)(2)(D), a provision added in a 1984 amendment, specifically excludes partnership interests from among the classes of property eligible for 1031 exchange tax deferral, whether the partnership interest is relinquished property or replacement property.

Given the foregoing constraints, a taxpayer who is a partner in a partnership may ask: "*So what if I take a distribution of a fractional interest in the relinquished property in liquidation of my partnership interest ahead of the sale and transfer my newly acquired interest in the investment property to the buyer as part of a standard delayed exchange?*" This strategy is sometimes referred to as a "drop and swap." Alternatively, an exchanger taxpayer may complete a 1031 exchange in a manner consistent with the taxpayer's longstanding ownership structure and, following the exchange, contribute the replacement property to a partnership or distribute the replacement property to the partners as tenants-in-common. This strategy is sometimes referred to as a "swap and drop." Either approach presents an issue under Section 1031 to the extent that the partnership and the partner or tenants-in-common, as the case may be, are considered different legal entities for purposes of federal income tax laws.

Regardless of the holding period issue associated with the "drop and swap" or "swap and drop" approaches, there are several Ninth Circuit cases that have permitted deferral despite a change in the form of ownership immediately before the exchange or after the completion of the exchange. A 2009 Order of the Oregon Tax Court in *Dep't of Revenue v. Marks*, Or. Tax (Case No. TC 4797; http://www.ojd.state.or.us/tax/taxdocs.nsf/.

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