How Long Must Like-Kind Exchange Properties Be Held?

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I. Introduction

Section 1031(a) of the Internal Revenue Code provides that except for some types of property, no gain or loss shall be recognized if property held for productive use in a trade or business or for investment is exchanged solely for property of like kind to be held either for productive use in a trade or business or for investment.

The statute requires that both the relinquished (old) property and the replacement (new) property involved in the exchange must be *held* for investment or for use in a trade or business, but the statute is silent about *how long* those properties have to be so held.

In 1989, as part of the legislation that became the Omnibus Budget Reconciliation Act of 1989, Congress attempted to impose a one-year holding requirement on both the relinquished property and the replacement property. The House version of the bill included that holding requirement,[1] but the Senate version did not.[2] The conference agreement adopted the Senate's version.[3] The statute does not specify how long the exchange properties must be held.

Thus it appears that establishing that the taxpayer held the properties for investment or for use in a trade or business is more important than the length of time they were held.

To determine the taxpayer's intent in holding the exchange properties, the courts have looked at the taxpayer's activities involving the properties before and after the exchange. Many cases and rulings have addressed that issue.

II. IRS Rulings

In several rulings, the IRS has concluded that if the taxpayer acquires the relinquished (old) property immediately before the exchange, or disposes of the replacement (new) property immediately after the exchange, the holding requirement of section 1031(a) isn't met.

Three rulings (Rev. Ruls. 75-291, 77-297, and 84-121) focus on the relinquished (old) property. In those rulings, the taxpayer wished to acquire the other party's property but the other party didn't want the taxpayer's property. So the taxpayer found property suitable to the other party, acquired it, and then exchanged it. The IRS ruled that the taxpayer acquired the property solely for the exchange.

In Rev. Rul. 75-291,[4] Corporation Y entered into an agreement to acquire a factory and land held by Corporation X. Under the agreement, Corporation Y purchased another tract of land, on which it built a factory. When the construction was completed, the two corporations exchanged the two properties. Regarding Corporation Y, the IRS ruled that the exchange didn't qualify under section 1031(a) because Corporation Y acquired the land and newly built factory solely for the exchange, didn't hold it for investment, and never used it in its business.

In Rev. Rul. 77-297,[5] a taxpayer agreed to sell a ranch that he held for business purposes if the buyer would cooperate by making the transaction a section 1031(a) exchange and by finding suitable replacement property. Under the agreement, the buyer purchased another ranch and exchanged it for the taxpayer's ranch. Regarding the buyer, the IRS ruled that the exchange didn't qualify under section 1031(a) because the buyer acquired the second ranch solely for the exchange and did not hold it for investment or for use in his business.

And in Rev. Rul. 84-121,[6] Taxpayer A, who used a parcel of land in his business, granted an option to Taxpayer B to acquire the land for use in Taxpayer B's business. Taxpayer B exercised the option, but instead of paying cash for the land, Taxpayer B purchased a second parcel of land from a third party and transferred it to Taxpayer A. Regarding Taxpayer B, the IRS ruled that the exchange didn't qualify under section 1031(a) because Taxpayer B never held the second parcel of land for investment and never used it in his business.

Two rulings (Rev. Ruls. 75-292 and 77-337) focus on the replacement (new) property in a corporate formation/liquidation context.

In Rev. Rul. 75-292,[7] in a prearranged transaction, an individual transferred land and buildings used in her business to an unrelated corporation in exchange for land and an office building used in the corporation's business. Immediately after the exchange, the individual transferred the land and office building to a newly created

[1] *See* H.R. 3299, 101st Cong., 1st Sess. (1989).

[2] *See* S. 1750, 101st Cong., 1st Sess. (1989).

[3] *See* H. Rep. No. 101-247, 1339-1342, 101st Cong., 1st Sess. (Sept. 20, 1989) and H. Rep. No. 101-386, 613-614, 101st Cong., 1st Sess. (Nov. 21, 1989).

[4] Rev. Rul. 75-291, 1975-2 C.B. 332.

[5] Rev. Rul. 77-297, 1977-2 C.B. 304.

[6] Rev. Rul. 84-121, 1984-2 C.B. 168.

[7] Rev. Rul. 75-292, 1975-2 C.B. 333.

corporation. Regarding the individual, the IRS concluded that the exchange didn't qualify under section 1031(a) because the individual didn't hold the land and office building for investment or for use in a business, but rather transferred them to the newly created corporation.

In Rev. Rul. 77-337,[8] in a prearranged transaction, the taxpayer received a shopping center in liquidation of his wholly owned corporation and immediately exchanged it for like-kind property held by an unrelated party. The IRS concluded that the exchange didn't qualify under section 1031(a) because the individual didn't hold the shopping center for investment or for use in a business.

Also, the IRS has issued a private letter ruling that a taxpayer who held the replacement property received in a section 1031(a) exchange for two years before selling it satisfied the holding requirement. According to the facts of that ruling, a trust that held rental property (a beach house) wished to exchange it with an individual that held other rental property (a residence). Initially, the trust intended to sell the residence immediately after the exchange was completed. The IRS ruled that the exchange wouldn't qualify under section 1031(a) because the trust intended to sell the replacement property (residence) immediately after the exchange rather than hold it for investment or for use in a business.[9]

The trust then resubmitted its ruling request stating that it intended to hold the residence for at least two years after the exchange was completed, and the IRS reversed its previous ruling.[10] The IRS stated that holding the replacement property for two years was a ''sufficient period'' to satisfy the holding requirement of section 1031(a). Although private letter rulings can't be relied on as precedent,[11] that ruling does reveal the IRS's position that holding replacement property for a two-year period is sufficient to satisfy the holding requirement.[12]

The IRS issued another private letter ruling that the termination of a trust that occurs soon after the receipt of replacement property in an exchange will not affect the holding requirement.[13] In that ruling, a trust desired to exchange its 1,600 acres of farmland for other property. The trust was due to terminate when the youngest living child reached 25 years of age, which was imminent. The trust asked the IRS whether termination of the trust a few months after the exchange would invalidate the section 1031(a) holding requirement, and the IRS confirmed that it would not.

[8]Rev. Rul. 77-337, 1977-2 C.B. 305.

[9]LTR 8310016 (Dec. 1, 1982).

[10]LTR 8429039 (Apr. 17, 1984).

[11]Section 6110(j)(3).

[12]Private letter rulings may be cited to show the practice of the commissioner. *See Rauenhorst v. Commissioner*, 119 T.C. 157 n.8, *Doc 2002-22803, 2002 TNT 195-13* (2002), *citing Rowan Cos., Inc. v. United States*, 452 U.S. 247, 261 n.17 (1981); *Hanover Bank v. Commissioner*, 369 U.S. 672, 686-687 (1962); *Estate of Cristofani v. Commissioner*, 97 T.C. 74, 84 n.5 (1991); *Woods Inv. Co. v. Commissioner*, 85 T.C. 274, 281 n.15 (1985); *Thurman v. Commissioner*, T.C. Memo. 1998-233, *Doc 98-21105, 98 TNT 126-4*.

[13]LTR 8126070 (Mar. 31, 1981).

III. Court Decisions

Court decisions on this topic have considered whether the relinquished (old) property was held for investment or for use in a business (*Loughborough Development Corporation, Barker, Neal T. Baker Enterprises Inc.*, and *Bolker*) and whether the replacement (new) property was held for investment or for use in a business (*Black, Klarkowski, Bernard, Wagensen, Click, Land Dynamics, Magneson*, and *Maloney*). Two cases have considered miscellaneous holding arguments (*Allegheny County Auto Mart Inc.* and *124 Front Street Inc.*). A few cases have considered the ''drop and swap'' and ''swap and drop'' transactions (*Bolker, Maloney*, and *Magneson*).

A. Holding the Relinquished (Old) Property

In *Loughborough Development Corporation v. Commissioner*,[14] the taxpayer was a corporation whose business was to buy and sell real estate (that is, a real estate dealer). During the tax year, the corporation exchanged some of its real estate for other real estate and cash and reported the cash as income on its return. The government argued that the corporation was a real estate dealer, that it held the real estate primarily for sale, and that therefore the entire gain realized on the exchange was taxable. The corporation argued that it held the real estate for investment purposes and that only the cash received was taxable. The real estate that the corporation gave up in the exchange was a portion of a larger parcel. Because the corporation had never sold any of the real estate in the larger parcel and was holding it to await future growth and development of the city in which that parcel was located, the court held that the corporation was holding the real estate for investment, not primarily for sale.

In *Barker v. United States*,[15] the taxpayer (Barker) entered into an agreement with another individual (Keeling) in which the taxpayer would find property suitable to Keeling and then exchange it for Keeling's 50-acre parcel of farmland in Champaign County, Ill. The taxpayer purchased property in Kankakee, Ill. (the Kankakee property) and on the same date exchanged it for Keeling's 50-acre property. That is similar to Rev. Ruls. 75-291, 77-297, and 84-121, discussed above. The district court held that at the exchange, the taxpayer did not hold the Kankakee property for investment or for use in a business but rather had acquired it solely for the exchange, and therefore was not entitled to defer the gain under section 1031(a).

In *Neal T. Baker Enterprises Inc. v. Commissioner*,[16] the taxpayer (a corporation) was a real estate developer and subdivider. In 1978 the corporation purchased a tract of land in Beaumont, Calif., that had been zoned for single-family residential use. The corporation already had a tentative map approved for development of 48 residential lots. In 1988 a company known as Gold Coast approached the taxpayer to acquire the 48 lots. In 1989

[14]*Loughborough Development Corporation v. Commissioner*, 29 BTA 95 (1933).

[15]*Barker v. United States*, 668 F. Supp. 1199 (C.D. Ill. 1987).

[16]*Neal T. Baker Enterprises Inc. v. Commissioner*, T.C. Memo. 1998-302, *Doc 98-26033, 98 TNT 161-4*.

the corporation transferred the 48 lots to an intermediary who then sold them to Gold Coast. The intermediary then used the funds to purchase four commercial properties and transferred them to the corporation to complete the exchange. The court determined that at the exchange, the corporation held the 48 lots primarily for sale, not for investment, and therefore the exchange resulted in taxable gain.

In *Bolker v. Commissioner*,[17] the taxpayer (Joseph Bolker) and his wife were 50-50 shareholders of Crosby Estates Inc., a corporation that owned real property in Montebello, Calif., that it held as an investment. On March 13, 1972, Crosby Estates Inc. liquidated and transferred all its assets, including the Montebello property, to Mr. Bolker.[18] On the same day, Mr. Bolker contracted with Southern California Savings & Loan (SCS) to exchange the Montebello property for other properties that Mr. Bolker would later identify. The exchange occurred three months later when, on June 30, 1972, Mr. Bolker transferred the Montebello property to SCS and received three other properties held by SCS.

Since the facts of *Bolker* were similar to the facts in Rev. Rul. 77-337 (corporate liquidation immediately followed by an exchange), the IRS argued that Mr. Bolker did not hold the Montebello property for investment or for use in a business.[19]

The Tax Court held that the exchange qualified for nonrecognition treatment under Section 1031(a), and, on appeal, the Ninth Circuit Court of Appeals agreed. In addressing whether Mr. Bolker had held the Montebello property for investment, the appeals court said:

> Authority on this issue is scarce. This is not surprising, because in almost all fact situations in which property is acquired for immediate exchange, there is no gain or loss to the acquiring taxpayer on the exchange, as the property has not had time to change in value. * * * The cases generally address the taxpayer's intent regarding the property *acquired* in an exchange, rather than the property *given up*. The rule of those cases, *e.g., Regals Realty Co. v. Commissioner*, 127 F.2d 931 (2d Cir. 1942), is that at the time of the exchange the taxpayer must intend to keep the property acquired, and intend to do so with an investment purpose. That rule would be nonsense as applied to the property given up, because at the time of the exchange the taxpayer's intent in every case is to give up the property. No exchange could qualify.[20]

The appeals court pointed out that Rev. Ruls. 77-337 and 77-297 (discussed above) were factually distinguishable from Mr. Bolker's situation because they both involved a prearranged plan under which the taxpayer immediately exchanged property that had been acquired solely for the exchange and, in both rulings, the taxpayer never held the relinquished property. The court stated that the distinguishing facts in Mr. Bolker's case were that the corporate liquidation was planned before any intention arose to exchange the properties, the liquidation was not intended to facilitate an exchange, and Mr. Bolker actually held the Montebello property for three months before the exchange occurred.

B. Holding the Replacement (New) Property

1. Intent to sell. In *Black v. Commissioner*,[21] the taxpayer exchanged desert land she was holding for investment purposes for a house, a mortgage, and cash. She painted the house and moved into it so she could make some repairs. When the work was completed, she listed the house for sale and sold it. The Tax Court ruled that the taxpayer did not intend to hold the replacement property for investment or for use in a trade or business. Rather, she intended to sell the house because she painted it, made repairs, and listed it for sale. Therefore, she was not entitled to defer the gain on the exchange.

In *Klarkowski v. Commissioner*,[22] the taxpayer exchanged commercial rental property held for investment purposes for 66 acres of vacant land. At the exchange, the taxpayer was involved in negotiations to acquire the adjacent 94-acre tract and combine it with the 66-acre tract so that the entire 160 acres could be developed into a residential subdivision. Three months later, the taxpayer transferred the 66-acre tract to a trust, and four months after that, the trust acquired the 94-acre tract. During the following five years, the 160-acre tract was subdivided and sold. The issue was whether the taxpayer, at the exchange, held the 66-acre tract for investment purposes. The Tax Court held that the taxpayer intended to hold the 66-acre tract primarily for sale.

In *Bernard v. Commissioner*,[23] the taxpayer and another individual formed a partnership. The partnership owned a 78.5-acre parcel of real property near Modesto, Calif., that the partners wanted to sell. They entered into an agreement to exchange their 78.5-acre parcel for a 50-acre parcel of property also near Modesto. The partners inserted a contingency into the exchange agreement requiring the 50-acre parcel to be sold for cash to a third party after the exchange was completed. Two weeks after the exchange, the partners sold the 50-acre parcel to a third party. The Tax Court ruled that the partners never intended to hold the 50-acre parcel for investment or for use in their business, but rather, primarily for sale, as evidenced by the contingency in the exchange agreement and subsequent sale. Consequently, the exchange didn't qualify under section 1031(a).

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[17] *Bolker v. Commissioner*, 760 F.2d 1039 (9th Cir. 1985), *aff'g* 81 T.C. 782 (1983).

[18] At the time, the corporation did not have to recognize gain on the liquidation due to section 336. That section was repealed for liquidations after Dec. 31, 1986.

[19] The IRS also argued that Crosby Estates Inc., not Mr. Bolker, made the exchange, but that argument failed in Tax Court and the IRS dropped the argument on appeal.

[20] *Bolker v. Commissioner*, *supra* note 17, at 1043 (emphasis in original).

[21] *Black v. Commissioner*, 35 T.C. 90 (1960).

[22] *Klarkowski v. Commissioner*, T.C. Memo. 1965-328, *aff'd on other issues*, 385 F2d 398 (7th Cir. 1967).

[23] *Bernard v. Commissioner*, T.C. Memo. 1967-176.

2. Intent to gift. In *Wagensen v. Commissioner*,[24] the taxpayer exchanged his ranch (Wagensen Ranch) for another ranch (Napier Ranch). The exchange began on January 18, 1974, when the taxpayer received a deed to the Napier Ranch, and was completed on October 15, 1974, when he deeded the Wagensen Ranch to the other party. During that nine-month period, the taxpayer used the Napier Ranch in his ranching partnership business. On September 21, 1974, before the exchange had been completed, the taxpayer told his two children that he intended to give the Napier Ranch to them, and in fact, less than one month after the exchange was completed, he made the gifts. The IRS argued that at the exchange, the taxpayer intended to make a gift of the Napier Ranch and therefore did not hold it for investment or for use in a trade or business. The court held that because the taxpayer had in fact used the Napier Ranch in his ranching partnership business for nine months, he satisfied the holding requirement of section 1031(a).

In *Click v. Commissioner*,[25] the taxpayer exchanged her farm for two residences, cash, and a note. On the same day, her two children and their families moved into the two residences. About seven months later, the taxpayer gave the residences to her two children. The IRS argued that she didn't hold the two residences for investment or use in a business, but rather for giving them to her children. Citing *Wagensen*, the taxpayer argued that at the exchange, she didn't intend to give the residences, but rather, she formed the intent seven months after the exchange. However, there was evidence that about a year before the exchange, the taxpayer was looking to acquire residential properties to give to her children, so the court did not believe her.

3. No proof of intent. In *Land Dynamics v. Commissioner*,[26] the taxpayer (a corporation) acquired 60 acres of raw land in Fresno, Calif., developed the land into an orange grove, building, and pipeline, and about three years later exchanged the property for 1,315 acres of grassland in Tulare County. After holding the Tulare County property for about a year, the corporation sold it. The IRS argued that the gain on the exchange was taxable because the corporation held the Tulare County property primarily for sale. The only evidence of the corporation's intent in holding the Tulare County property was a prospectus it had later issued for the sale of some stock. The prospectus described the corporation's business as acquiring land for use in real estate projects. The prospectus specifically stated that the corporation did not acquire land for investment. With no other evidence, the court held that the corporation had not satisfied its burden of proving that it held the property for investment, and therefore the exchange did not satisfy the holding requirement of section 1031(a).

4. Continuation of investment. In *Magneson*[27] the taxpayer exchanged investment property for an undivided 10 percent interest in other investment property. Immediately thereafter, the taxpayer contributed the undivided 10 percent interest in the investment property to a partnership in exchange for a 10 percent general partnership interest. The IRS argued that the taxpayer had not held the undivided 10 percent interest in the property for investment or for use in a business. The court ruled that the exchange qualified for tax-deferred treatment under section 1031(a) because the contribution of the undivided 10 percent interest to a partnership was a continuation of the taxpayer's investment and ownership of the property. The court ruled that holding an interest in a general partnership that owned real property wasn't substantially different from holding an interest in the real property itself.

In *Maloney v. Commissioner*,[28] the issue was transferee liability[29] asserted against an individual who had owned 100 percent of the stock of a liquidated corporation. The corporation had owned a piece of real estate near New Orleans known as the ''I-10 property'' that it held as an investment. On December 28, 1978, the corporation exchanged the I-10 property and cash for other property near New Orleans known as ''Elysian Fields.'' At the exchange, the corporation intended to liquidate and distribute its assets to the taxpayer. Five days after the exchange, the corporation adopted a plan of liquidation, which it completed about a month later. The individual received Elysian Fields in the liquidation. The IRS argued that at the exchange, the corporation did not hold Elysian Fields for investment or for use in its business, but rather it had intended to distribute the property to the individual in the liquidation. Citing *Bolker*, the Tax Court held that the liquidation did not invalidate the tax-free nature of the exchange. The court explained that the corporation merely changed the form in which Elysian Fields was held from a corporation owned 100 percent by the individual to the individual's 100 percent ownership.

C. Miscellaneous Holding Arguments

In *Allegheny County Auto Mart Inc. v. Commissioner*,[30] a corporation transacted a simultaneous exchange involving two different lots on the same street in Pittsburgh. On September 15, 1947, the corporation's board of directors authorized the purchase of five lots on Baum Boulevard. On October 27, 1947, the corporation entered into an agreement to purchase one of those lots (5860 Baum Boulevard), and on November 7, 1947, entered into a separate agreement to sell that lot to an individual (Marcus) and acquire a nearby lot (5820 Baum Boulevard) held by Marcus. On January 2, 1948, the corporation acquired title to 5860 Baum Boulevard. Five days later on January 7, 1948, the corporation transferred 5860 Baum Boulevard to Marcus and received 5820 Baum Boulevard from Marcus. The corporation sustained a loss on the exchange, which it deducted on its return.

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[24]*Wagensen v. Commissioner*, 74 T.C. 653 (1980).

[25]*Click v. Commissioner*, 78 T.C. 225 (1982).

[26]*Land Dynamics v. Commissioner*, T.C. Memo. 1978-259.

[27]*Magneson v. Commissioner*, 753 F.2d 1490 (9th Cir. 1985), *aff'g* 81 T.C. 767 (1983).

[28]*Maloney v. Commissioner*, 93 T.C. 89 (1989).

[29]*See* section 6901(a).

[30]*Allegheny County Auto Mart Inc. v. Commissioner*, 12 T.C.M. (CCH) 427 (1953), PH T.C.M. para. 53,140 (1953), *aff'd*, 208 F.2d 693 (3d Cir. 1953).

The IRS disallowed the loss, arguing that the corporation's transfer of 5860 Baum Boulevard to Marcus and its acquisition of 5820 Baum Boulevard from Marcus on January 7, 1947, was an exchange that required nonrecognition of the loss.[31] The corporation argued that the two transactions were separate. The Tax Court agreed with the IRS, and the appeals court affirmed.

In *124 Front Street Inc. v. Commissioner*,[32] the taxpayer held an option to acquire property located at 124 Front Street in San Francisco. Firemen's Insurance Company was interested in acquiring that property. The taxpayer didn't have enough money to pay the option price, so Firemen's agreed to lend funds to the taxpayer. The taxpayer exercised the option and acquired the property, which was then held in an escrow account. About 4½ months later, Firemen's acquired property located at 240 Stockton Street in San Francisco, and under the exchange agreement between the taxpayer and Firemen's, the taxpayer exchanged 124 Front Street for 240 Stockton Street. The IRS argued that there were two transactions — a sale followed by a purchase — and not an exchange. The Tax Court held that the transaction qualified as an exchange under section 1031(a). Because the taxpayer exercised the option and held 124 Front Street for about 4½ months before exchanging it with Firemen's, the transaction qualified as a valid exchange.[33]

IV. 'Drop and Swap' Transactions

A ''drop and swap'' transaction is one in which a taxpayer who owns an interest in a partnership receives a distribution of an undivided fractional interest in real property held by the partnership and, shortly thereafter, relinquishes the property in a section 1031(a) exchange. The distribution from the partnership is usually tax-free.[34] There is also a ''swap and drop'' transaction in which the partnership exchanges the real property first and then distributes the replacement (new) property to the partner.

The question in the drop and swap transaction is whether the partner has held the relinquished property (the property received in the ''drop'') for investment or for use in a business, even though the partner held it for only a brief period. Similarly, the question in the swap and drop transaction is whether the partnership held the replacement property (the property received in the ''swap'') for investment or for use in a business, even though the partnership held it for only a brief period.

One example of the drop and swap transaction is *Bolker v. Commissioner*, discussed earlier. The decision in *Bolker* supports the concept that as long as there is no prearranged plan, a taxpayer need not hold the relinquished (old) property for very long before giving it up in an exchange. *Bolker* also stands for the principle that the taxpayer's intention for holding the properties is determined at the time of the exchange.[35]

Even if there is a prearranged plan, the IRS might not necessarily prevail. *Maloney v. Commissioner* (discussed earlier) is an example of a prearranged swap and drop transaction. In that case, in a prearranged transaction, a corporation exchanged investment property for other investment property and about a month later liquidated and distributed the replacement property to its shareholder. The Tax Court held that only the form in which the investment was held had changed (from a corporation owned 100 percent by the individual to the shareholder's 100 percent ownership), so the exchange qualified under section 1031(a).

Magneson v. Commissioner (discussed earlier) is a variation of the swap and drop transaction. In an exchange, the taxpayer received an undivided 10 percent interest in investment property and immediately contributed the undivided 10 percent interest to a partnership for a 10 percent general partnership interest. The court ruled that the exchange qualified under section 1031(a) because the partnership interest was a continuation of the taxpayer's investment.

Chase v. Commissioner[36] involved a failed attempt to create a drop and swap transaction. The taxpayer (Mr. Chase) and an unrelated corporation (Triton Financial Corp.) formed a general partnership to own and operate the John Muir Apartments in San Francisco. Two years later, they received an offer to buy the apartment building, which they accepted. Mr. Chase wanted to transact an exchange to avoid tax on the gain. To accomplish that, the partnership gave him a deed for his 46.3527 percent of the apartment building. He intended to exchange that through an intermediary for replacement property, but that's not what happened.

Several facts indicated that the substance of the transaction was a sale, not an exchange. The deed was not recorded. Unilateral distribution by the partnership of Mr. Chase's share of the building was specifically prohibited by the partnership agreement. The sale of the apartment building fell through and was renegotiated showing the partnership as the only seller (rather than the partnership and Mr. Chase as sellers). Between (1) the time the partnership gave Mr. Chase the deed and (2) the date of the sale, the partnership received all the income and paid all the expenses of operating the apartment building, rather than the partnership and Mr. Chase sharing those items. The partnership paid for all the selling expenses, rather than the partnership and Mr. Chase sharing them. Mr. Chase had his share of the sales proceeds paid to a trust (acting as an intermediary), and subsequently the trust acquired replacement property.

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[31]The applicable statute was section 112 of the 1939 code, which was similar to current section 1031.

[32]*124 Front Street Inc. v. Commissioner*, 65 T.C. 6 (1975), *acq.* 1976-2 C.B. 2, *nonacq.* 1976-2 C.B. 3.

[33]The IRS acquiesced in the Tax Court's holding that the funds advanced to the taxpayer were a loan rather than ''boot'' (1976-2 C.B. 2), but it nonacquiesced in the remainder of the decision (1976-2 C.B. 3). The IRS didn't appeal. Eight years later the IRS issued Rev. Rul. 84-121, *supra* note 6, containing similar facts.

[34]*See* section 731(a)(1).

[35]That principle is also supported by *Click v. Commissioner*, *supra* note 25, at 231 (1982); *Klarkowski v. Commissioner*, *supra* note 22; and *Magneson v. Commissioner*, *supra* note 27.

[36]*Chase v. Commissioner*, 92 T.C. 874 (1989).

The Tax Court held that, in substance, Mr. Chase did not acquire an ownership in the apartment building. Rather, the partnership was the seller of the entire property. Mr. Chase's exchange failed because he had no property to relinquish in the exchange.

The court did not specifically reject the drop and swap transaction for section 1031 exchanges. Rather, it held that because of the unique facts involved, the substance of the transaction was that no drop occurred.

Those cases demonstrate that if the drop and swap and swap and drop transactions are carefully planned and carried out properly, taxpayers may receive tax-deferred treatment under section 1031(a). However, the court cases are limited to their unique facts — liquidation of an entity to its owners followed by an exchange of property by the owners, and transfer of the replacement property to a general partnership. What if the transactions involved a nonliquidating distribution, a limited partnership, or a limited liability company?

V. Use of LLCs

It has become rather commonplace among many real estate investors to use LLCs to hold their real estate investments. Each LLC usually holds only one or two real estate investments. While liquidation of an LLC to its members followed by an exchange by one or more members will probably qualify under section 1031(a) thanks to *Bolker*, the IRS may attack the transaction if the exchange was part of a prearranged plan or for other reasons.

For example, suppose an LLC holding an apartment building has three members, each with a one-third ownership of the LLC. One of the members wishes to invest in another type of property. The LLC dissolves and distributes to each of its members an undivided one-third interest in the apartment building. One member exchanges his one-third interest in the building with an unrelated individual and receives undeveloped land that he then contributes to a new LLC in exchange for a 100 percent membership interest. The IRS might argue that the transactions, taken together, constitute a prearranged plan to exchange a one-third interest in an LLC for a 100 percent interest in an LLC. That exchange would be prohibited by section 1031(a)(2)(D) (exchange of partnership interests).[37]

VI. Analysis and Conclusions

Most tax advisers tell their clients that the properties involved in an exchange should be held for as long as possible to establish that they were held for investment or for use in the client's business. I have heard tax practitioners cite anywhere from six months to two years as the length of time the exchange properties should be held.

However, the mere length of time that the exchange properties are held is not necessarily determinative. If the relinquished (old) and replacement (new) properties have been held for some period of time (even a few days), and if the objective facts indicate that the taxpayer's intent was to hold both properties for investment or for use in a business, it is likely that the taxpayer will satisfy the holding requirement of section 1031(a).

What general principles can be drawn from the cases and rulings? The IRS and the courts have indicated that the determination of whether the taxpayer has satisfied the holding requirement depends on all the facts and circumstances of the particular situation and the taxpayer's intent. The cases and rulings suggest that:

- Taxpayers intending to acquire the relinquished (old) property immediately before the exchange or to dispose of the replacement (new) property immediately after the exchange are at risk of an IRS attack. If possible, those transfers should not be part of a prearranged plan.
- Disposing of the replacement (new) property immediately after the exchange is riskier than acquiring the relinquished (old) property immediately before the exchange (*Bolker*).
- Taxpayers involved in a drop and swap or swap and drop transaction must be careful to structure and complete the transactions properly, but even if they do, they could be at risk of an IRS attack.

[37]*See* Lipton, ''The 'State of the Art' in Like-Kind Exchanges, Revisited,'' 98 *Journal of Taxation* 334 (June 2003), and Lipton, ''The 'State of the Art' in Like-Kind Exchanges, 2006,'' 104(3) *Journal of Taxation* 138 (Mar. 2006), who suggests that the IRS might use the step transaction doctrine to make this argument. The step transaction doctrine is a judicially developed concept that treats a series of separate ''steps'' as a single transaction if the steps are ''in substance integrated, interdependent and focused toward a particular end result.'' *See* Rev. Rul. 79-250, 1979-2 C.B. 156, *modified by* Rev. Rul. 96-29, 1996-1 C.B. 50, *Doc 96-15358, 96 TNT 102-6*; *Penrod v. Commissioner*, 88 T.C. 1415, 1428 (1987); *Estate of Christian v. Commissioner*, T.C. Memo. 1989-413. A more complete discussion of the step transaction doctrine is beyond the scope of this article.