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NEW YORK TAX COURT APPROVES "DROP AND SWAP" TECHNIQUE IN REAL ESTATE LIKE-KIND EXCHANGE

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An IRC § 1031 like-kind exchange ("LKE") is a tax-deferred transaction in which the taxpayer sells real estate held for productive use in a trade or business or for investment ("qualifying property") and reinvests the sales proceeds in other qualifying property. If done correctly, the taxpayer can defer the payment of income tax on the gain realized from the sale of the relinquished property.

When a partnership (or limited liability company taxed as a partnership) wishes to sell real estate, one or more owners may wish to cash out their share while other owners may wish to reinvest in new real estate through a like-kind exchange. To achieve these competing objectives, a technique commonly referred to as a "drop and swap" may be employed whereby the entity first distributes (the "drop") its real estate to the individual owners as tenants-in-common. Subsequently, the individuals owners either sell their TIC interests for cash in a taxable transaction or exchange their TIC interests for other qualifying property in a LKE (the "swap"). Unfortunately there is no specific legal guidance which defines how long the real estate must be held before the sale to meet the "held for" requirement. Therefore, the risk inherent in the "drop and swap" strategy is that the IRS may challenge the LKE treatment by the exchanging owners on the basis that they held their real estate interests for sale rather than for a business or investment purpose if the sale occurs close in time to the "drop".

In a notable win for real estate investors earlier this year in *In the Matter of Hadar & Shamron*, DTA Nos. 850122 and 850123 (6/12/25), the New York Tax Appeals Tribunal upheld the validity of a "drop and swap" exchange. In the transaction, Benjamin Hadar, Ruth Shamron and a third partner owned an appreciated apartment building through a partnership. To allow Hadar and Shamron to reinvest their share of the proceeds from the sale of the building by a LKE, while the third partner cashed out, the partnership first distributed the building to the partners as tenants-in-common. On the same day, the individual TIC owners sold their TIC interests and Hadar and Shamron used their proceeds to purchase qualifying property in a LKE through a qualified intermediary. The Tax Appeals Tribal decision upholding tax-deferred treatment emphasized that:

- IRC § 1031 does not impose a specific minimum holding period requirement for the relinquished property;
- Hadar and Shamron followed the proper form of their transaction by:
  - recording deeds which evidenced the transfer of the building to the three partners as TIC owners;
  - reporting the interim transfers for real estate transfer tax purposes despite the short duration of TIC ownership prior to the sale;
  - identifying themselves as TIC owners in the sale documents;
  - entering into a TIC agreement;
- The lender was aware of, and did not object to, the distribution of the TIC interests
- Hadar's and Shamron's shares of the sales proceeds were deposited with separate qualified intermediaries in the names of the TIC owners

Proper planning, detailed documentation and strict adherence to the form of the transaction seemed to be key considerations in the Tax Appeal Tribunal's decision to uphold the LKE treatment and may provide a strong roadmap for successfully implementing a compliant "drop and swap" transaction. Importantly, however, the *Hadar/Shamron* decision is not binding on the IRS or other states which may still challenge the "drop and swap" transaction. Therefore, taxpayers should still proceed with caution when considering this strategy.

The "drop and swap" technique is complex and requires careful legal and tax planning, as it can be scrutinized by the IRS, especially if the "drop" happens immediately before the sale. If you have any questions regarding this alert, please contact your Cummings & Lockwood private clients attorney.