# Like-Kind Exchanges – The Basics and Some Planning Tips to Help You Guide Your Clients

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Internal Revenue Code Section 1031[2] is a provision in the United States Tax Code that allows taxpayers to defer capital gains and recapture tax on qualifying exchanges of real property. This deferred technique is also commonly known as a "like-kind exchange." Section 1031 like-kind exchanges can provide significant tax deferral (and in some cases tax avoidance). The purpose of this article is to review the general rules of Section 1031 and highlight planning issues in Section 1031 transactions for attorneys to consider.

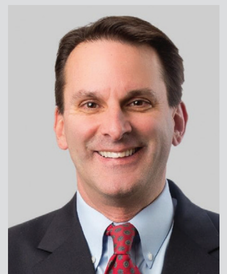
## BACKGROUND OF INTERNAL REVENUE CODE SECTION 1031

Congress enacted Section 1031 in 1954 to provide specific rules and regulations for like-kind exchanges. To qualify under Section 1031, several requirements must be met. First, there must be an exchange of real estate (normally, selling one real property (the "relinquished property") and acquiring another real property (the "replacement property")).

Second, each property must be **held for** productive use in a trade or business, or for investment purposes.[3] This means that the property must not be held for personal use or for sale to customers in the ordinary course of business.

Third, the properties being exchanged must be of "like-kind."[4] Real properties are like-kind if they are of the same nature or character, even if they differ in quality or grade or they are improved or unimproved. A taxpayer cannot sell real estate and reinvest the proceeds into personal property – it has to sell real estate and purchase another parcel of real estate.

Fourth, a qualified intermediary



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1 I.R.C. §1031.
2 I.R.C. §1031.
3 I.R.C. §1031(a)(2); Treas. Reg. §1.1031(a)-1(a)(1).
4 Treas. Reg. §1.1031(a)-1(b).

must hold the proceeds from the sale of the relinquished property[5] until used to purchase a replacement property and the replacement property must be identified in accordance with Section 1031 and its regulations. After the sale of the relinquished property, the taxpayer must (i) identify potential replacement properties within 45 days of closing, and (ii) complete the purchase of the replacement property within 180 days of the closing.[6] These time frames are strictly construed and cannot be extended even if the 45th day or 180th day falls on a Saturday, Sunday or legal holiday. Unless both time frames are met, the taxpayer will not qualify for Section 1031 treatment.

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**BENEFITS OF INTERNAL REVENUE CODE SECTION 1031**

A primary benefit of Section 1031 is the ability to defer capital gains taxes on the sale of property. Instead of paying taxes on the gain from the sale, the taxpayer can reinvest all of the proceeds and defer the tax liability until the sale of the replacement property. Although Section 1031 provides a **deferral** of gain and not an **exclusion** from gain, if the taxpayer holds the replacement property until death, the taxpayer's family can receive a stepped-up basis in the replacement property and avoid the gain entirely.[7]

Another benefit of like-kind exchanges is the ability to consolidate or diversify property holdings. For example, a taxpayer may own several rental properties in different locations and desire to consolidate them into one larger property. Alternatively, a taxpayer may want to diversify their property holdings by exchanging a single property for several smaller properties in different locations. Timing is a key component in either scenario.

A like-kind exchange can allow a taxpayer to sell a property that requires active management for one that does not, such as a long-term triple net lease. A long-term triple-net lease allows a property owner to receive a monthly rent check with few responsibilities.

Finally, a Section 1031 transaction can also, when structured properly, allow a taxpayer to receive some cash payout after purchasing the replacement property. Many commentators believe that a "nanosecond" after purchase, a replacement property can be leveraged to provide the taxpayer with cash proceeds.[8] In this planning, there should be a separate closing with a separate closing statement between the title company, the property owner and the property owner's lender.

**THE ROLE OF THE QUALIFIED INTERMEDIARY**

IRC Section 1031 requires a "qualified intermediary" to hold the proceeds from a sale to be used as directed by a taxpayer to reinvest in another property in order to obtain a deferral of gain.[9] Many parties can be a qualified intermediary – it is good practice to use a company which specializes in those services to ensure the exchange is handled properly.

Section 1031 provides that the taxpayer cannot access the funds held by the qualified intermediary, and the qualified intermediary must hold the sales proceeds until the later of (i) 180 days or (ii) the date direction is given release funds to purchase a replacement property. That said, certain expenses of sale and purchase (attorney fees and title fees, among others) may be paid from those funds by the qualified intermediary.[10]

A qualified intermediary will require documents to be signed before proceeds are transferred to the qualified intermediary. It is best to have these documents executed prior to closing. Additionally, a real estate contract should specify that the seller has a right to engage in a Section 1031 exchange and to require the buyer to cooperate.

**IDENTIFICATION RULES**

There are specific rules when a taxpayer identifies replacement properties in writing to the qualified intermediary. A taxpayer can identify potential replacement properties under one of three rules. The first rule is the Three (3) Property Rule which limits the total (aggregate) number of potential replacement properties identified to three (3).[11] The second rule is known as the 200% Rule which allows a taxpayer to identify more than three (3) replacement properties if the total (aggregate) fair market value of the identified properties does not exceed 200% of the Gross Sale Price of the relinquished property.[12] The limitation is only on the total value and not on the number of properties identified. The third rule is the 95% Rule, which does not limit the number or value of identified like-kind replacement properties but requires the taxpayer to close on 95% of the value of the identified properties to qualify for Section 1031 treatment.[13]

**TAX PLANNING CONSIDERATIONS**

5 Treas. Reg. §1.1031(k)-1(g)(4).
6 Treas. Reg. §1.103(a)-1(b).
7 I.R.C. 1014.
8 *The "State of the Art" in Like-Kind Exchanges, Revisited*, Richard M. Lipton, Journal of Taxation, June 2003, p. 343.
9 Treas. Reg. §1031(k)-1(g)(4).
10 Revenue Ruling 72-456; IRS Private Letter Ruling 8328011.
11 Treas. Reg. §1031(k)-1(c)(4)(i)(A).
12 Treas. Reg. §1031(k)-1(c)(4)(i)(B).
13 Treas. Reg. §1031(k)-1(c)(4)(ii).

To achieve 100% income tax deferral the purchase price of the replacement property must be equal to or greater than the sales price of the relinquished property. A taxpayer cannot just invest net proceeds from the sale. That means if a relinquished property had a mortgage on it, a taxpayer would have to invest funds or obtain a loan to purchase a replacement property to achieve 100% tax deferral.

If the purchase price of the replacement property is lower than the sales price of the relinquished property, then the taxpayer will be taxed at capital gain rates (and potential recapture gain) on the difference. This gain is not computed pro-rata based on the percentage of the sales price – instead, the difference is taxed fully up to the amount of the gain on the sale of the relinquished property. For this reason and others, I recommend involving the client's CPA throughout the process.

In addition to an increased in basis to fair market value at the time of the taxpayer's death,[14] some commentators believe the use of what is referred to as a "general power of appointment" can cause the tax basis in a real estate asset to increase upon the death of a party other than the taxpayer, such as a parent (a discussion of such planning is beyond the scope of this article).

## CHALLENGES INVOLVING PARTNERSHIP/LLC OWNERSHIP

Properties eligible for Section 1031 treatment are often owned in a partnership (or a limited liability company (an LLC)), with multiple owners. These owners often have different opinions on what to do with the sale proceeds - some partners want cash proceeds and other partners want a Section 1031 deferral. The rules of Section 1031 provide that the taxpayer that sells a relinquished property must also be the buyer of the replacement property. If a partnership sells real estate, the individual partners cannot purchase a replacement property and qualify for Section 1031 deferral treatment – only the **partnership** can get Section 1031 treatment.

When there is such a difference of opinion, the owners can deed the property out to the owners as tenants-in-common and execute a tenant in common agreement to document the rights and obligations of all parties. Timing is key in such a situation. Practitioners often recommend that a tenant-in-common structure be established 12 months before the distributed property is sold to avoid the IRS from arguing that the real estate parcels were not being "held for" investment (or trade or business) purposes, based upon a Congressional proposal in 1989 (HB 3150) that the relinquished and replacement properties be held for one year to qualify for Section 1031.

If a client in this situation intends to sell within 12 months, all is not lost. The Ninth Circuit's decision in *Bolker v. Commissioner* affirmed a Tax Court ruling allowing for Section 1031 non-recognition, where a corporation liquidated and the real property in the corporation was conveyed to the corporation's individual shareholder, who exchanged the real property for like kind property three months later. In supporting taxpayer's position, the Ninth Circuit held:

> the intent to exchange property for like-kind property satisfies the [use] requirement because it is *not* an intent to liquidate the investment or to use it for personal pursuits. [Taxpayer] acquired. . .[real] property (from the liquidation) with the intent to exchange it for like-kind property, and thus he held [the real property received in liquidation] for investment under Section 1031(a).[15]

Under *Bolker,* if the holder of property had the intent to continue an investment in real estate, and not liquidate it, the holder may satisfy the "held for" requirement of Section 1031.

## PLANNING TAKEAWAYS

In all events, when looking at potential tax issues in Section 1031 planning, all practitioners (attorney, accountant and real estate broker, among others) need to make sure all potential avenues for gain deferral are checked and addressed. Some of those issue include:

- Having a taxpayer's CPA or other accountant calculate taxes due on sale when a client indicates a desire to sell.
- If real estate is owned by an entity, find out if all owners want to sell and reinvest proceeds in real estate.
- If needed, set up a tenant-in-common ownership structure.
- Have your client look at replacement properties when the relinquished property is listed, especially considering the 45-day rule – some clients even know what their replacement property will be at the closing of the relinquished property.
- Make sure the contracts for the relinquished and replacement property transactions allow for Section 1031 treatment to occur, and have each party required to sign documents to comply with Section 1031 requirements.
- Know the amount to be reinvested to get a 100% income tax deferral, as well as the tax exposure if not all funds needed for 100% income tax deferral are reinvested in a replacement property.
- Engaging a Qualified Intermediary early in the sales process.
- Make sure all documents for the qualified intermediary are signed before closing on the relinquished property (or, if necessary, at the closing).
- Be mindful of the 45/180 day rules.

14 I.R.C. §1014.

15 *Id.*