

The Basics of Like-Kind Exchanges

What is a Like-Kind Exchange?

A like-kind exchange generally allows a taxpayer to defer the recognition of gain on the sale of property if the taxpayer acquires like-kind replacement property in a transaction that meets the requirements of the Regulations, and other rulings, under Internal Revenue Code Section 1031. These exchanges are often referred to as "1031 exchanges" after the section of the Internal Revenue Code which allows them.

What are the benefits of a Like-Kind Exchange?

- Tax deferral - generally provides the ability to defer the recognition of gain from the sale of property indefinitely. Taxpayers can continue to exchange qualified property that is used in a trade or business or held for investment, deferring gains until the last property is sold for cash.
- Diversification of holdings – allows investors to diversify property holdings. By engaging in a like-kind exchange, a taxpayer can exchange several properties for a single property (providing some management relief), switch the type of investment property (i.e. from residential to commercial) or diversify the location of their investments, all on a tax deferred basis.
- Estate planning – can be used to avoid the frustrations and hardships caused by leaving one large property to multiple family members. By exchanging one large property for several smaller ones, each family member has the ability to hold or sell their piece of property as they see fit.

Requirements for Full Tax Deferral

To fully defer all gain on sale, the following two requirements must be met:

1. The taxpayer must acquire like-kind property with an acquisition cost that is equal to or greater than the net sale price of the property sold.
2. The taxpayer, through a Qualified Intermediary, must reinvest 100% of the cash received from the sale in qualified like-kind property. To the extent the taxpayer receives non like-kind property in the exchange (including cash), gain will be recognized in an amount equal to the FMV of this non like-kind property to the extent of the realized gain on the transaction.

What is Like-Kind Property?

With respect to real property, the term "like-kind" is very broadly defined. Most real property used in a trade or business or held for

investment will be considered to be like-kind to other types of real property. For instance, raw land is generally considered like-kind to a building and a commercial property is generally considered like-kind to residential property.

The rules for personal property like-kind exchanges are more stringent. The exchange must be of personal property within the same NAICS product class or general asset class.

Certain property including inventory, stocks and bonds, and partnership interests are specifically excluded from section 1031 and cannot be exchanged on a tax deferred basis.

What are the Types of Exchanges?

A simultaneous exchange occurs when property is exchanged directly for other property at the same time. An example of this would be when a taxpayer exchanges one automobile for another automobile.

A deferred exchange occurs when a taxpayer engages a Qualified Intermediary (QI) and enters into an Exchange agreement with the QI to sell his property, known as the relinquished property, and at a later date purchases like-kind replacement property. This type of exchange is more common, but must satisfy several additional requirements to be done on a tax deferred basis. For example, qualified replacement property must be identified in writing within 45 days after the sale of the relinquished property and the purchase of the replacement property must be completed within 180 days from sale date of the relinquished property, or the due date of the tax return if earlier (note – the due date of the tax return can be extended).

When the replacement property is purchased before the relinquished property is sold, the exchange is referred to as a reverse exchange. In a "safe harbor" reverse exchange, the taxpayer must identify the property to be sold within 45 days of purchasing the replacement property and must complete the exchange within 180 days. This type of exchange can be considerably more complex than a deferred exchange.

Should I Consider a 1031 Exchange?

Like-kind exchanges offer the ability to simplify and diversify certain investments while deferring the recognition of gain. Each taxpayer must consider their long term investment goals and other economic factors, such as current and future tax rates and the cost and availability of financing, before answering this question. These considerations, along with an analysis of the specific transaction, will determine whether the use of this taxpayer favorable code section is right for you.