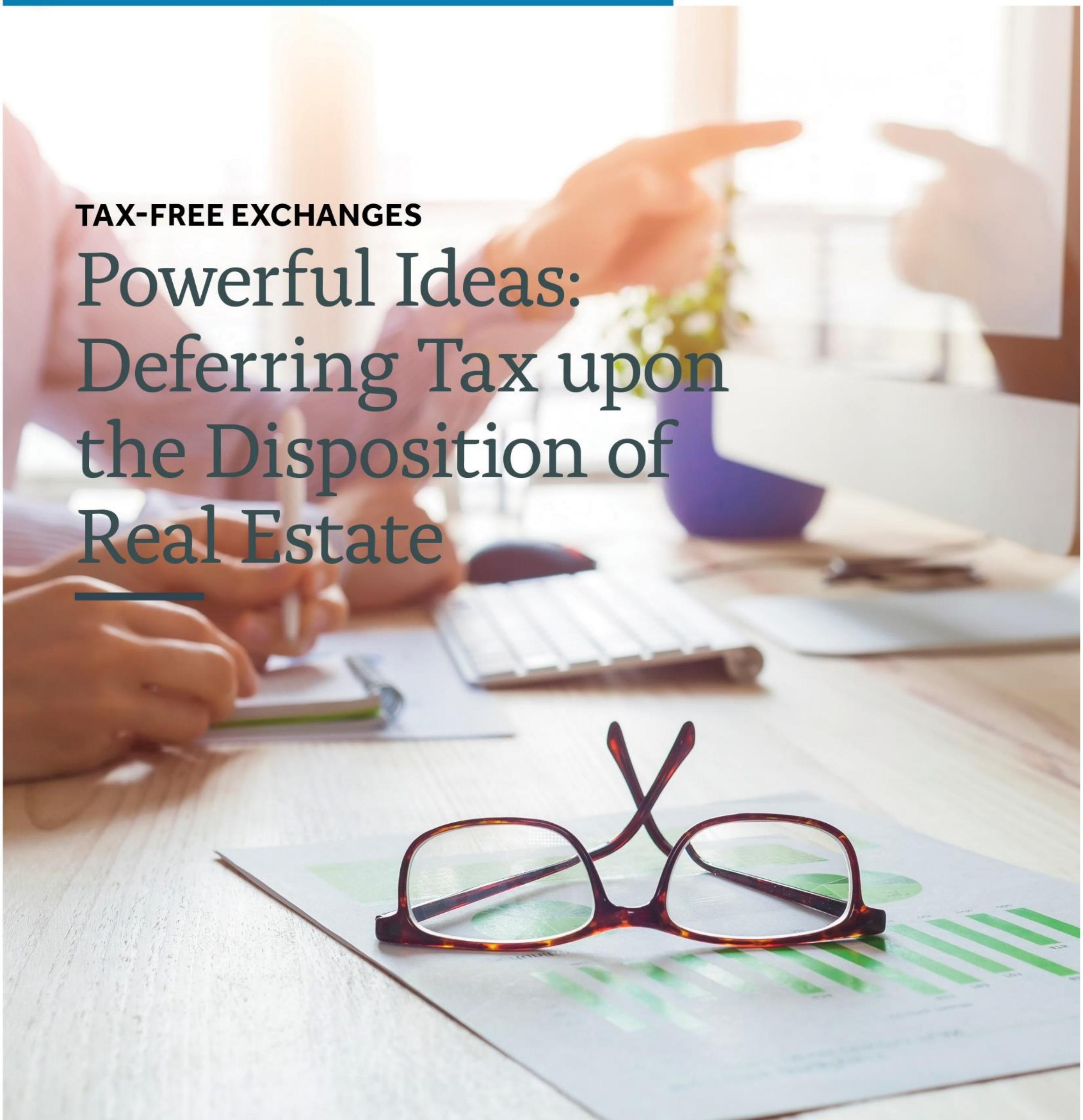
Navigating
Income Tax



TAX-FREE EXCHANGES

Powerful Ideas: Deferring Tax upon the Disposition of Real Estate

Deferring Tax Upon the Disposition of Real Estate

Like-Kind Exchanges – In General

For the person holding appreciated real estate property who wants to dispose of it and replace it with other property, a like-kind exchange can be an effective way of doing so without incurring a current tax liability. While a taxpayer who sells appreciated property must generally recognize the gain or loss from the sale and pay taxes on any resulting gain in the year of sale, the like-kind exchange provisions of Internal Revenue Code (IRC) §1031 provide that no gain or loss will be recognized when appreciated property held for productive use in a trade or business (or for investment) is exchanged for like-kind property that will also be held for productive use in a trade or business (or for investment). Recognition of the gain is then deferred until the property received in the exchange is disposed of in a subsequent taxable transaction.

Like-kind exchanges are valuable tools utilized for purposes of deferring the recognition of income. If done properly, no income tax should result from a like-kind exchange. Because the Tax Cuts and Jobs Act of 2017 (TCJA) narrowed the type of property that qualifies for like-kind exchange treatment for exchanges completed after December 31, 2017, the nonrecognition of gain or loss under the like-kind exchange rules is now limited to the exchange of real property that is not held primarily for sale.

Qualifying Property

Several requirements must be met to qualify for like-kind exchange treatment. As §1031 only applies to real property, any personal property transferred in a like-kind exchange is considered separately bought and sold, with undeferrable gain on the sale. If the taxpayer also receives money, relief from debt, or nonqualified property in the exchange, the gain is taxable to the extent of such money, debt relief, and the fair market value (FMV) of the disqualified property.

Qualifying relinquished and replacement property must satisfy two core requirements: (1) the property must be real property, and (2) the two types of property must be of like-kind to one another. Treasury Regulations §1.1031(a)-1(b) state that the words "like-kind" refer to the nature or character of property, and courts generally hold that to mean virtually any real property is of like-kind to virtually any other real property, regardless of whether improved or unimproved. In sum, the TCJA made the key inquiry in most cases the examination of what constitutes real property.

The final regulations classify property as real property for Sec. 1031 purposes if the property is:

- Classified as such under the state and local law test, subject to certain exceptions;
- Specifically listed as real property in the final regulations; or
- Considered real property based on all the facts and circumstances.

In addition to updating the definition of real property, the IRS finalized a rule providing that exchange funds can be used to purchase real property that contains incidental personal property. Personal property is incidental to real property acquired in an exchange if (1) in standard commercial transactions, the personal property is typically transferred together with the real property, and (2) the aggregate FMV of the incidental personal property transferred with the real property does not exceed 15% of the aggregate FMV of the replacement real property.

Deferred Exchanges

One particularly important requirement addressed by the regulations requires that the deal must be structured as an exchange; taxpayers cannot sell, get the proceeds, and then buy. Rather, they must either trade the property directly or use a qualified intermediary to buy and sell such that it looks like an exchange from the taxpayer's perspective. A deferred exchange occurs when a property is transferred before a replacement property has been chosen.

To qualify for a deferred exchange, a replacement property must be identified within 45 days of transferring the property. If a property is not identified within 45 days, the transaction will fail. In order to meet the requirement of identifying a replacement property, the transferor must finalize the transfer sale within this time limit or comply with one of the following:

- Identify up to three alternate properties;
- Identify as many replacement properties as he/she wishes, so long as the aggregate value of all properties does not exceed 200% of the FMV of the exchanged property; or
- Identify any number of replacement properties so long as the FMV of the properties actually received at the end of the exchange period is 95% of the aggregate FMV of all properties identified.

Lastly, to qualify, (1) the replacement property must be received within 180 days of the transfer, or (2) by the due date of the income tax return, including extensions, for the year in which the property is relinquished.

In contrast to a deferred exchange, a reverse exchange occurs when replacement property is identified before the original property has been transferred. In a reverse exchange, the transferring party engages an exchange accommodation titleholder. The exchange accommodation titleholder receives the replacement property and holds it for up to 180 days, at which time the transferor must transfer the original property to close the exchange.

Is There a Required Holding Period?

The parties to a like-kind exchange are generally required to maintain their interests in the property being exchanged before and after the exchange and continue to hold the property for business use or for investment purposes. Except for related parties, there is no bright line rule requiring the properties be held for a certain amount of time. Rather, the IRS and tax courts look to the intent of the taxpayer at the time of the exchange. If it is the taxpayer's intent at the time of exchange to hold the property for business use or investment purposes, the transaction will generally be respected even where conditions may change.

If a taxpayer completes an exchange of like-kind property with a related person, and the taxpayer or the related person disposes of the like-kind property received in the exchange within two years after the date of the last transfer made to complete the exchange, the nonrecognition of gain on the exchange is disallowed. A related person includes one's spouse, lineal heirs, descendants, and siblings. Exceptions to the denial of like-kind treatment are provided in the event of death, compulsory or involuntary conversion, or a showing that the transaction did not have the avoidance of federal income tax as one of its principal purposes.

Who Can Do an Exchange and How Is It Reported?

All property owners – whether individuals, disregarded entities, partnerships, or corporations – are eligible to engage in a like-kind exchange, so long as the requirements listed above are met.

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