The Return of 1031 Like-Kind Exchanges

~ James L. Turner

One of the most powerful tax deferral tools available is a "1031 like-kind exchange." This tool, which is described under Section 1031 of the Internal Revenue Code, typically rises in popularity when capital gain tax rates increase.

The renewed interest in making like-kind exchanges to defer the tax on capital gains arises from two developments. First, the Affordable Care Act introduced a new tax on the net investment income of high-income individuals. Net investment income is defined to include capital gains. This tax on individuals is 3.8 percent on the lesser of their (i) net investment income (broadly defined) or (ii) modified adjusted gross income over specified threshold amounts. Second, the maximum rate on long-term capital gains increased from 15 percent to 20 percent for 2013. Therefore, the combined maximum tax bracket for capital gains is now 23.8 percent instead of the 15 percent rate that applied in 2012. As a result, like-kind exchanges are more relevant today than they have been in recent years.

Like-kind exchange basics

Under Section 1031, no gain or loss is recognized if property you held for productive use in a trade or business, or for investment is exchanged solely for "like-kind" property also to be held for productive use in a trade or business, or for investment. The trade-off for this nonrecognition is that the adjusted basis of the property you acquired in the exchange—for depreciation and gain or loss purposes—will be the same as the adjusted basis of the relinquished property. Therefore, the tax is generally deferred until you sell the replacement property.

Taxable boot on partial like-kind exchange: netting of liabilities

If property you received in an exchange comprises like-kind property qualifying for Section 1031 treatment, plus other property that is not "like-kind" or money ("nonqualifying property" or "boot"), the gain recognized for tax purposes, with some limited exceptions, is limited to the money and the fair market value of the other nonqualifying property you received. Nonqualifying property received includes cash received to pay off an existing mortgage on the relinquished property, as well as liabilities attaching to the property you relinquish in an exchange, whether the purchaser of that property assumes those liabilities or takes the property subject to those liabilities. However, existing regulations—and subsequent interpretations

of them—provide that debt incurred or assumed on the acquisition of replacement property offsets debt relief on the disposition of relinquished property for purposes of calculating taxable boot.

This may seem confusing, so let's look at an example: If the replacement property you acquired is encumbered by a $4 million mortgage, and if there is a $3 million mortgage on the property you relinquished, that $3 million existing mortgage is netted against the $4 million new debt on the replacement property, meaning that the $3 million of debt relief on your relinquished property will not cause a gain to be recognized. However, if you carried a $3 million mortgage on the relinquished property and take out only a $2 million mortgage on the replacement property, the $1 million net debt relief would be taxable boot.

Calculation of boot: seek professional advice

The rules that apply to how much of the gain realized on a partial exchange is recognized for tax purposes are complicated and can be counterintuitive. If you have an $8 million sale of a property with a $3 million tax cost basis, there is $5 million of gain realized. Therefore, you might assume that only the $5 million gain must be reinvested in replacement property. If you assume that to be true, then you would be mistaken. In another example, if $4 million (half of the price of the $8 million property you sold) of replacement property is purchased in the exchange, you might assume that half of the $5 million gain on the sale of the relinquished property would be deferred in the exchange. That would also be incorrect. The correct answer depends on whether and how the relinquished property's tax cost basis is applied to reduce the taxable gain or whether the tax cost basis instead gets applied as basis in the replacement property.

Given these complicated rules, you should consult your tax advisor to determine what the tax consequences will be in each contemplated exchange.

Identity of party selling relinquished property and buying replacement property

If you are the buyer of the replacement property, you must also be the seller of the relinquished property, or at least you must be considered to be the same party as the seller for federal income tax purposes. While this may not be difficult to manage if you, as an individual, are the relinquished property's sole owner, questions can arise if the property has multiple owners. If the co-owners are deemed, in form or substance, to own the relinquished property in a partnership, then the replacement property must be purchased in the name of the same partnership. One may be deemed by the IRS to own property in a partnership regardless of how record title is held. If co-owners own the relinquished property as tenants-in-common with each owning an undivided interest, each co-owner may make a separate decision about whether to exchange or to sell for cash and pay the tax, and about what property to exchange if a co-owner exchanges. However, the distinctions between a partnership and a co-tenancy are subtle, so if you are in a co-ownership situation, discuss this issue with your tax advisor.

Exchanged properties must be held for trade or business, or for investment

The properties you exchange must be held for productive use in a trade or business, or for investment. Neither can be held as inventory for resale. Neither of the properties you exchange can be real property used exclusively for personal purposes at the time of the exchange, such as a vacation home. If, after the exchange, you convey the replacement property to either a related or an unrelated party too soon after it is acquired—or if there is evidence you are holding the replacement property under a prearranged plan to sell it—that might disqualify the exchange because the replacement property would not have been held "for investment."

What constitutes like-kind property?

Under Section 1031 of the Internal Revenue Code, the words "like-kind" refer to the nature or character of the property one is relinquishing and acquiring as replacement property, not to the property's grade or quality. One kind or class of property may not be exchanged under Section 1031 for property of a different kind or class. An exchange of real property for personal property does not qualify, because the property's nature or character is not of like-kind.

Transferring trade or business property in exchange for services does not constitute a like-kind exchange, since services are not like-kind to improved real property. Therefore, the cost of any improvements you may make to the replacement property after you acquire it will not qualify as replacement property. If this is an issue you foresee, discuss it with your tax advisor, as there are planning opportunities here.

The kinds of real estate that can be exchanged within Section 1031 are broad. Examples of like-kind property include exchange of city real estate for a ranch or farm and real property exchanged for a lease with 30 years or more to run on real property. That property is improved or unimproved relates only to its grade or quality and not to its kind or class. Therefore, improved real property will qualify as like-kind to unimproved real property.

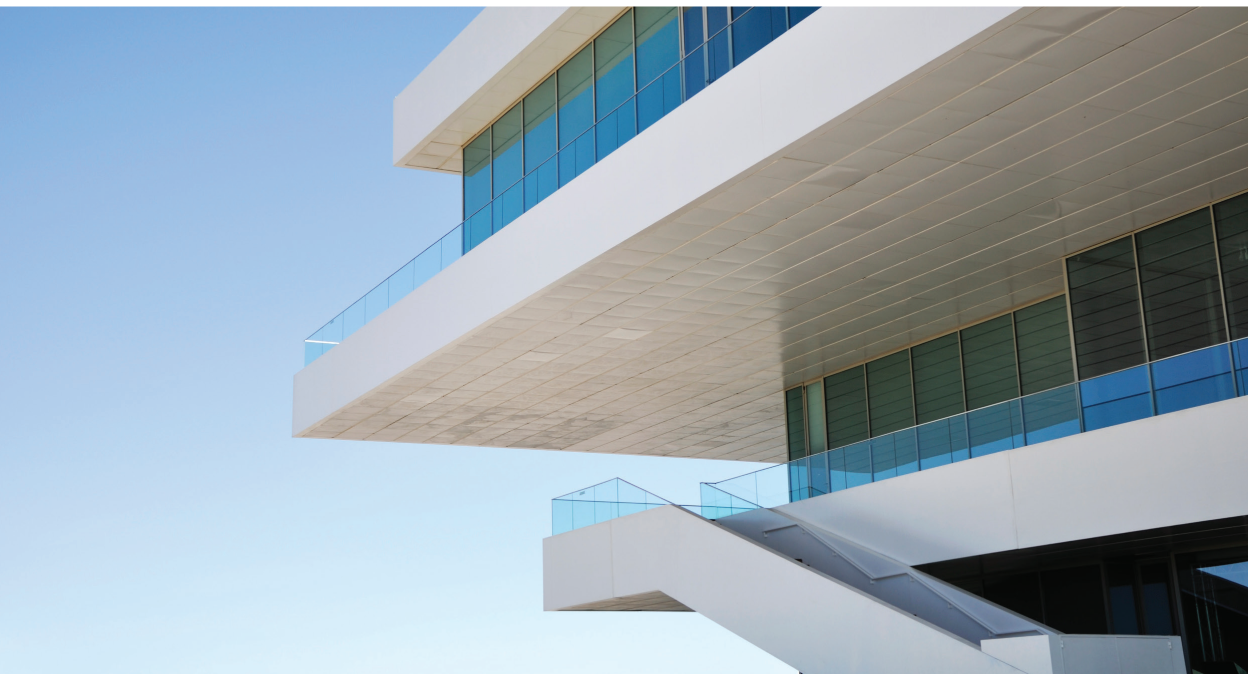
In addition, an exchange of business or investment personal property (e.g., equipment, furnishings, motor vehicles) for other such personal property also falls within Section 1031 as like-kind. However, there is little guidance about when personal property (as opposed to real property) is considered to be of like-kind to other personal property, though the regulations provide some guidance. Because these rules are technical, if you are including personal property in the property being relinquished in the exchange, discuss these rules with your tax advisor.

Deferred like-kind exchange: basic rules

At one time, the IRS claimed that the reciprocal transfer of like-kind properties must be simultaneous. However, the Treasury has since adopted regulations that allow for deferred, non-simultaneous exchanges, and transactions are commonly structured today to comply with those regulations.

To do a deferred exchange, you will need to select a qualified intermediary ("QI") who is not deemed your agent for tax purposes to receive and hold the sale proceeds under an exchange agreement, since receipt of proceeds from your disposition of the relinquished property, either by you or by your agent, would invalidate the attempted Section 1031 transaction.

Section 1031 also provides two timing restrictions that, if not met, will disqualify a deferred exchange from nonrecognition treatment. The first is that the replacement property you intend to acquire must be identified to the QI within 45 days after transferring your relinquished property. The second is that the replacement property you intend to acquire must be transferred no later than the earlier of (i) 180 days after the date you dispose of the relinquished property or (ii) the due date (with extensions) of the federal income tax return for the year in which the transfer of the relinquished property takes place.



The regulations provide two basic options relating to the number of properties that may be identified as replacement properties. You, as the taxpayer, may identify three alternative properties without regard to which of the three you intend to acquire. If you identify more than three properties, the total value of all identified properties must be limited to 200 percent of the relinquished property's value. Failure to comply with one of these two options may invalidate the entire exchange since, if these limits are exceeded, it is treated as though none of the identified properties has been properly identified. You are permitted, however, to change the properties identified by revoking some identifications and substituting others during the 45-day identification period, as long as the limits at the end of the period are satisfied.

Restricted access to sales proceeds in deferred exchange

The IRS considers the right to elect to receive cash instead of property to be the equivalent of receiving cash. Therefore, provisions required by the regulations are inserted in the typical exchange agreement to avoid "constructive" receipt of cash. You cannot have the right to change your mind and elect to receive cash prior to the completion of the full 180-day exchange period that starts with transferring the relinquished property, unless you fail to identify any properties within the 45-day identification period or those that you identified have either all been acquired or prove impossible to acquire due to circumstances beyond your control. Except in limited circumstances, until the entire 180-day exchange period passes without using up the net proceeds from the disposition of the relinquished property to acquire replacement property, you cannot elect to receive cash instead of property. If you know you want to use some proceeds, which are not intended to be used to acquire replacement property, before the end of the 180-day exchange period, consider making only a partial assignment of the sales contract to the QI, so you can receive the balance of the proceeds at closing. That decision must be made before closing the relinquished property's sale and should be discussed with your tax advisor. The exchange agreement should also provide that you have no right to assign or pledge your interest in the escrowed funds.

Reverse exchanges: acquisition of replacement property before sale of relinquished property

In 2000, the IRS published a Revenue Procedure containing guidance concerning the qualification of reverse exchanges as like-kind exchanges under Section 1031. A reverse exchange occurs when a taxpayer acquires title to replacement property before disposing of the relinquished property. The Revenue Procedure requires that an exchange accommodation titleholder ("EAT") either hold title to the replacement property while the taxpayer attempts to sell the relinquished property or that an EAT take title to the relinquished property when the taxpayer acquires the replacement property and hold the relinquished property until the taxpayer sells it. The goal is that the taxpayer will not own both properties simultaneously. A detailed review of the reverse exchange rules is beyond this article. However, although the EAT holds title and is treated as the owner of the parked property for federal income tax purposes, the taxpayer can bear most of the practical risks of

ownership, including the ability to make loans to the EAT to acquire the replacement property, and guarantees of and indemnities against obligations, costs, and expenses incurred by the EAT to acquire the replacement property. The replacement property can be leased to or otherwise managed by the taxpayer. Similar to the timing rules in a forward deferred exchange, the taxpayer must identify the relinquished property under the 1031 regulations (i.e., the "three-property" or "200 percent" rule) no later than 45 days after transfer of the replacement property to the EAT. In addition, regardless of whether the EAT holds replacement property or relinquished property, the EAT cannot hold it for over 180 days, and the combined period that the relinquished property or the replacement property is held under the Qualified Exchange Accommodation Agreement cannot exceed 180 days.

Related party exchanges

Section 1031 of the Internal Revenue Code includes a provision that will affect and possibly restrict exchanges between related parties, such as members of a family or entities under common control. If you intend to name alternate replacement properties owned, in whole or in part, by a related party or by an entity owned in part by a related party, consult your tax advisor.

Conclusion

Every exchange circumstance is different, and there are other rules and opportunities that may apply to particular situations. Before selling any business or investment property, consult a tax advisor about the potential tax deferral you may achieve through a like-kind exchange. Under the right circumstances, the tax that can be deferred may be significant.

Jim is a shareholder with Williams Parker.
He is also a CPA and regularly represents family business owners, entrepreneurs, and real estate investors in tax, transactional, financing, operational, succession, and estate planning matters. Jim has substantial experience throughout Southwest Florida with acquisitions, development, operations, financing, and tax planning related to commercial real estate. Of particular note, Jim is known statewide for his representation of developers, owners, and operators of manufactured housing communities and RV parks.