

# Like-Kind Exchanges



Gain from the sale of investment property held for a period of less than one year is taxed as ordinary income and is therefore subject to federal income tax as high as 35%.

## 1031: INTRODUCTION

The sale of appreciated real property held for investment purposes can lead to substantial tax liabilities. Gain from the sale of investment property held for a period of less than one year is taxed as ordinary income and is therefore subject to federal income tax as high as 35%. If the investment property is held for a period of more than one year the gain is subject to the more favorable capital gains tax rate of 15%.

Internal Revenue Code (hereinafter "IRC") Section 1031 allows for deferral of recognition of capital gains as long as replacement property is purchased with the proceeds from the relinquished property. This means an investor can dispose of his investment property, use all of his equity to purchase replacement property and defer the recognition of capital gain; and, therefore, the payment of tax on the capital gain. **Two requirements must be met for tax on capital gains to be deferred: 1. the investor must acquire "like-kind" replacement property and 2. the investor cannot receive any cash; if cash is received it will be considered boot and will be taxable.**

## 1031: LIKE-KIND PROPERTY

In order for an investor to qualify for a "Like-Kind" exchange the relinquished property must be exchanged for replacement property that is of "like-kind." The definition of "like-kind" for exchange purposes is very broad; all real property is "like-kind" with other real property. Therefore, it is possible to exchange raw land for an apartment building, residential rental property for commercial rental property or commercial property for raw land. In most cases real property exchanged for other real property will qualify as a "like-kind" as long as both the relinquished property and the replacement property are held for investment purposes. It is important to point out that property located outside of the United States is NOT "like-kind" property and no tax deferred "like-kind" exchange can take place.



## 1031: BOOT

Boot is best described as property received in an exchange that is not of "like-kind;" items of personal property or cash. Sometimes in an exchange one party needs to contribute cash or other personal property to make the exchange "equal." In an exchange the receiver of "boot" will be required to pay tax on the fair market value of the "boot" received. Examples of "boot" are: stocks, bonds, notes, cash, partnership interests, debt relief and property intended for personal use.

If the exchange results in the reduction of debt for the



investor, the amount of the reduction in debt will be considered “boot” and will be taxable.

To avoid the receipt of boot the exchanger should be sure to acquire replacement property of equal or greater value than the relinquished property, reinvest all of the net equity from the sale of the relinquished property and secure equal or greater debt on the replacement property.

## 1031: TYPES OF EXCHANGES

### SIMULTANEOUS EXCHANGE

A simultaneous exchange is exactly what its name infers; the relinquished property and replacement property are transferred at the same time. It is recommended that a qualified intermediary be used in this transaction as to not put at the risk the intended tax deferred status of the capital gains.



### DELAYED EXCHANGE

Delayed exchanges are the most common type of exchange. In a delayed exchange the investor enters into a contract to sell the relinquished property. The investor then transfers the rights in the sales contract to the qualified intermediary. The qualified intermediary becomes the seller and transfers the relinquished property to the buyer.

The investor has 45 days from the close of escrow on the relinquished property to identify replacement property. Once replacement property is identified the investor has 180 days to close escrow on the replacement property. The qualified intermediary acquires the replacement property with the proceeds from the sale of the relinquished property and transfers the replacement property to the investor.

ment property to the investor.

It is important when contemplating an exchange under IRC Section 1031 that the investor put an “exchange cooperation” clause in both the sales contract for the relinquished property and the purchase contract for the replacement property.

### REVERSE EXCHANGE

Reverse exchanges are less common types of exchanges that are far more complicated than delayed exchanges. Reverse exchanges utilize “Holding Companies,” usually wholly owned subsidiaries of qualified intermediaries, where the investor can “park” the relinquished property or the replacement property.



“Parking the relinquished property” is probably the most complex exchange because it involves a concurrent exchange between the investor, the seller, the qualified intermediary and the holding company.

**Type One**

Reverse exchange type one is where the investor wishes to acquire replacement property before disposing of his relinquished property; “parking the replacement property”. In this instance the investor lends the money, or at least the down payment, to the holding company to purchase the replacement property. The holding company purchases the replacement property and leases it to the investor; this way the investor can have use of the property immediately. The investor, within 180 days, enters into a contract to sell the relinquished property, transfers the rights in the sales contract to the qualified intermediary who in turn transfers the relinquished property to the buyer. The proceeds from the sale are used by the qualified intermediary to purchase the replacement property from the holding company and transfer it to the investor. The holding company uses the proceeds from the sale of the relinquished property to repay the investor and any third-party lender that may have contributed capital.

**Type Two**

In the second type of reverse exchange the seller “parks the relinquished property.” This type of reverse exchange utilizes a simultaneous exchange to accomplish its intended purpose. In this transaction the investor has identified replacement property but has not yet disposed of his relinquished property. “Parking the relinquished property” is probably the most complex exchange because it involves a concurrent exchange between the investor, the seller, the qualified intermediary and the holding company.

The simultaneous exchange is completed in the following manner. The holding company acquires replacement property from the seller and, through the qualified intermediary, simultaneously exchanges it for the relinquished property. Since the relinquished property has not yet been sold to a “real” buyer the holding company will need to borrow, from the investor or third-party lender, the capital to purchase the replacement property. Once a suitable buyer for the relinquished property is identified the holding company will sell the relinquished property and use the proceeds to repay the loan used to purchase the replacement property.

**1031: QUALIFIED INTERMEDIARY**

A Qualified Intermediary, for purposes of IRC Sec. 1031, is a “middle man.” The investor enters into an exchange agreement with the qualified intermediary. Simply stated the qualified intermediary acquires the relinquished property from the investor (seller) and transfers it to the buyer. The proceeds from the sale of the relinquished property go directly to the qualified intermediary. When the investor identifies replacement property, in accordance with Internal Revenue Code and Treasury Regulations, the qualified intermediary will acquire the replacement property and transfer it to the investor.





The first timing restriction for a delayed “like-kind” exchange is for the seller to either close on replacement property or to identify the potential replacement property within 45 days from the date of transfer of the exchanged property.

**1031: TAX DEFERRED EXCHANGE**

Once the investor has found a willing buyer to purchase his property the property will be placed in escrow. Prior to the close of escrow on the relinquished property the investor must notify the escrow company that he wishes to enter into a “like-kind” exchange.

When the contingencies are satisfied and the contract is scheduled for escrow to close, the services of a qualified intermediary will need to be arranged for. The investor will enter into an Exchange Agreement with the qualified intermediary which will permit the qualified intermediary to become the “substitute seller” in accordance with the requirements of the Internal Revenue Code and Regulations.

The Exchange Agreement will usually provide for:

- An assignment of the seller’s Contract to buy and sell real estate to the Intermediary.
- A closing where the Intermediary receives the proceeds due the seller at closing.
- Direct deeding is used; the Exchange Agreement will comply with the requirements of the Internal Revenue Code and Regulations wherein the seller can have no rights to the funds being held by the qualified intermediary until the exchange is completed or the Exchange Agreement terminates. The seller cannot “touch” the funds.
- An interval of time where the seller proceeds to locate suitable replacement property and enter into a contract to purchase the property. The interval of time is subject to the 45-day and 180-day rules.
- An assignment of the contract to purchase replacement property to the qualified intermediary.
- A closing where the qualified intermediary uses the exchange funds in its possession and direct deeding to acquire the replacement property for the seller.



**1031: EXCHANGE RULES**

**The 45-Day Rule for Identification.** The first timing restriction for a delayed “like-kind” exchange is for the seller to either close on replacement property or to identify the potential replacement property within 45 days from the date of transfer of the exchanged property. The 45-Day Rule is satisfied if replacement property is received before 45 days has expired. Otherwise, the identification must be by written document (the identification notice) signed by

After 45 days, limitations are imposed on the number of potential replacement properties which can be received as replacement properties.

the seller and hand-delivered, mailed, faxed, or otherwise sent to the qualified intermediary. The identification notice must contain an unambiguous description of the replacement property. This includes, in the case of real property, the legal description, street address or a distinguishable name.

After 45 days, limitations are imposed on the number of potential replacement properties which can be received as replacement properties. More than one potential replacement property can be identified pursuant to one of the following three conditions:

- › **The Three-Property Rule** - Any three properties regardless of their market values.
- › **The 200% Rule** - Any number of properties as long as the aggregate fair market value of the replacement properties does not exceed 200% of the aggregate FMV of all of the exchanged properties as of the initial transfer date.
- › **The 95% Rule** - Any number of replacement properties if the fair market value of the properties actually received by the end of the exchange period is at least 95% of the aggregate FMV of all the potential replacement properties identified.

Although the Regulations only require written notification within 45 days, it is recommended practice for a solid contract to be in place by the end of the 45-day period. Otherwise, the seller may be unable to close on any of the properties which are identified under the 45-day letter. After 45 days have expired, it is not possible to close on any other property which was not identified in the 45-day letter. Failure to submit the 45-Day Letter causes the Exchange Agreement to terminate and the qualified intermediary will disburse all unused funds in its possession to the investor.

**The 180-Day Rule for Receipt of Replacement Property.** The replacement property must be received and the exchange completed no later than the earlier of 180 days after the transfer of the exchanged property or the due date (with extensions) of the income tax return for the tax year in which the relinquished property was transferred. The replacement property received must be substantially the same as the property which was identified under the 45-day rule described above. There is no provision for extension of the 180 days for any circumstance or hardship.

While Esquire Group, LLC uses reasonable efforts to include accurate and up-to-date information, we make no warranties or representations as to the accuracy of the Content and assume no liability or responsibility for any error or omission in the Content. Nothing herein shall be construed as tax or legal advice. The information contained herein is not a substitute for tax and legal advice and is provided for informational purposes only.

