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The Section 1031 Like-Kind Exchange

STILL ONE OF THE BEST TAX DEFERRAL PLANS

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INTRODUCTION

Many sellers of business or investment property continue to benefit from Internal Revenue Code ("IRC") Section 1031, which provides that gains on the sale of this property are deferred as long as the proceeds are similarly reinvested. The inherent gain is not taxed; rather, the built-in appreciation is carried over to the successor property. The result is that the property owner avoids the payment of gains tax until the property is eventually sold outright.

The Tax Cuts and Jobs Act of 2017 made a significant change to these rules, limiting like-kind exchanges to real property held for business or investment – no personal property any longer.

Given the popularity of this rule among those who use it regularly – particularly the real estate industry – it is hard to imagine that the like-kind exchange is due for repeal.

Why exchange? There are several key advantages to exchanging which may make the technical requirements worth the effort, which are –

- *Returns are reinvested entirely*. Just as an Individual Retirement Account can grow faster than other investments because of the full tax deferral on internal growth, the IRC 1031 exchange gives the taxpayer the same advantage for real estate and other business assets. The taxpayer may sell for reasons other than investment decisions, such as relocation or obsolescence. In these cases, the growth can continue unimpeded by tax on the appreciation.
- *Diversification*. The taxpayer may find that too much of their net worth is tied up in one or more investments, such as a particular commercial real estate building. The IRC 1031 exchange allows the taxpayer to sell that particular investment, reinvest the proceeds into several different replacement properties, and fully defer the tax bill.
- *Other motives*. The taxpayer may have other motives to sell the property which are not related to cashing out of that particular property. Such examples may include the need to separate the taxpayer from properties that require excessive time or travel to effectively manage, or if the taxpayer receives an offer to sell that "they cannot refuse", but want to remain in that business.

Statutory requirements. The law stipulates that several specific requirements be met in order to successfully defer all or part of the gain. Each of those requirements are explained as follows:

Held for productive use in a business or for investment. The first standard provides that the property must be either held as an investment or held for use in the taxpayer's business. The term "held" has never been officially defined, although it is assumed that the word carries the common meaning.

Further, the length of time an asset must be owned in order to be "held" for this purpose has never been absolutely determined. In negotiations over the Revenue Reconciliation Act of 1989, Congress considered (and later rejected) writing a one-year holding term into law. However, commentators have offered that this particular episode should neither suggest that a holding period of less than one year is insufficient, nor that a holding period of more than one year is safe from scrutiny.

Based on this standard, any property held for personal use, such as a vacation home, does not qualify for the deferral. However, the Internal Revenue Service ("IRS") has determined that minimal personal use of legitimate business property does not bar §1031 treatment[1].

An additional holding period requirement is imposed for exchanges between related parties. IRC §1031(f) provides that taxpayers who directly or indirectly exchange property with a related party must hold it for at least two years subsequent to the exchange. If either related party disposes of their property in those two years, both sales will be retroactively treated as a fully taxable transaction. Recapture exceptions are given for the death of either party and for involuntary conversions.

***The exchange*.** A key component of §1031 is that a true exchange take place. It is not enough to sell property, hold the funds in the bank, and later use those funds to purchase replacement property. If the taxpayer ever actually or constructively holds the proceeds from a sale of their property, then like-kind treatment is not available. In its purest sense, a qualifying exchange is a true trade or property with another taxpayer. In fact, the IRS took the position that a simultaneous reciprocal transfer was required to qualify. However, the Ninth Circuit Court ruled in 1979 that actual trade of the titles to property was not necessary, but merely that the seller(s) who desire like-kind treatment cannot receive sale proceeds[2].

At this point, note that a successful exchange in compliance with the rules of this section results in <u>mandatory</u> gain deferral. If all of the mandatory tests are successfully met, like-kind exchange treatment is not optional, but is required. For this reason, taxpayers should examine a planned reinvestment from the sale of business or investment property quite carefully. Some situations will exist where like-kind deferral treatment is not preferable and the requirements should be intentionally defeated. Consider two examples:

- Taxpayer has a built-in loss on the property he or she is about to sell. This is not as uncommon as it might seem – such is frequently the case with expensive business automobiles which have received limited depreciation. A trade with a car dealer for another car will generally be taxed as a §1031 exchange. Not only is the gain deferred in an exchange, but a loss is deferred as well. And, once again, the deferral treatment is mandatory. Therefore, it can be in the car owners' interest to try to structure the transaction so that §1031 fails, and the loss becomes currently deductible.

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[1] PLR 8103117.

[2] *Starker v. U.S.* 602 F2d 1341 (9th Circuit 1979).

- Taxpayer has a built-in loss on a particular tract of real estate due to a market downturn. If a potential buyer offers his property in return, the taxpayer should ensure that at least one of the §1031 requirements are not satisfied.

Property must be like-kind. Traditionally, personal property must be exchanged for personal property and real property for real. However, this was the rule before the enactment of the Tax Cuts of Jobs Act of 2017, which limited like-kind exchanges after 2017 to real property.

For personal property (pre-2018 rules), exchange treatment is most often seen in vehicles, although the application works quite well for collectibles held for investment. Most any type of personal property can qualify, as long as it otherwise satisfies the §1031 requirements. Generally, items of personal property qualify as like-kind as long as they are similar either by their nature or in the way they are used in the trade or business. The IRS has interpreted this rule to say that personal property be in the same general asset or product class.[3]

When applying these rules to personal property, care should be exercised to make sure that the properties are indeed like-kind. For example, the IRS has held that cars are not like-kind with trucks, and vice-versa. However, an SUV (sport-utility vehicle) is like-kind to both cars and trucks. In farming businesses, male cattle are like-kind with other male cattle, but not with female cattle. So, as you can see, the personal property like-kind distinctions are quite narrow.

For real property (the only option post-2017), the standard of like-kind is applied quite generously. In fact, even the real estate condition of improved or unimproved is not prohibitive, since that designates the property's grade or quality, not its kind[4]. In applying the real estate rule generously, the IRS has further determined that real estate and a long-term real estate lease are like-kind[5]. One notable prohibition is that real property inside the United States and foreign real estate are not like-kind[6].

After the transfer, the new property continues the tax attributes of the property traded away. These attributes include the date acquired, the depreciation elections, and the like. The basis of the old property carry over to the new, plus any exchange expenses and boot paid (generally meaning cash or other non-like-kind property transferred – discussed in detail later). However, note that the IRS has clarified the depreciation rules for replacement depreciable property.[7]

The like-kind rules do not require a one-for-one property exchange. In fact, there is no prohibition against exchanging, for example, a single real estate parcel valued at $5 million for several properties which, in the aggregate, are also worth $5 million.

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[3] Regulations §1.1031(a)-2(b). Asset classes are defined in Revenue Procedure 87-56, and product classes are found in the *Standard Industrial Classification Manual*.
[4] Regulations §1.1031(a)-1(b).
[5] Regs. §1.1031(a)-1(c).
[6] IRC §1031(h), added by the 1989 Revenue Reconciliation Act, effective for transfers after July 10, 1989.
[7] Notice 2000-4.

Property which cannot be exchanged under IRC §1031.

In an otherwise qualifying exchange, gain is recognized to the extent that non-§1031 property (including cash) is received.

> *For example*, John owns real estate worth $5 million with a basis of $2 million. His unrealized appreciation is $3 million. He exchanges with Bill in a qualifying exchange for Bill's real estate worth $4 million. To make up the difference, Bill includes $1 million cash in the trade. For John who receives $4 million in real estate and $1 million cash, the receipt of cash constitutes non-1031 property, as it is not like-kind property. As a result, $1 million of the $3 million gain is currently taxable, while the $2 million balance is deferred.
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> *For further example*, reconsider the above transaction from Bill's perspective. The prohibition against non-§1031 property in a qualifying exchange only relates to the receipt of property, not to the payment of property. Bill receives only real estate worth $5 million. Therefore, the transaction is tax-deferred for Bill, assuming all other conditions are met.

Non-qualifying property includes any property that is not like-kind. However, certain property can never be like-kind. These not only include cash, but stocks or bonds and inventory (which includes otherwise qualifying property, such as real estate, if the taxpayer is in the business of selling real estate).

Mixed classification property. Taxpayers should be careful when selling or acquiring mixed personal and real property in an exchange, since real property can only be exchanged for real property, not personal property. For example, a furnished condominium rental unit is both personal and real property to some extent. A taxpayer would not be able to fully defer the gain using a like-kind exchange unless the replacement property or properties had sufficient cost to absorb both the personal and real property components. Also, under the depreciation rules in the landmark case *Hospital Corporation of America*[8], some commercial properties may now be considered partially real and partially personal properties. Now, the personal part is no longer eligible for like-kind deferral treatment. See your tax adviser if these situations are the case.

Related parties. In December 2002, the IRS clarified its position on like-kind exchanges involving related parties. The IRS granted that a taxpayer may sell the property it relinquishes to a related party, but it may not buy replacement property from a related party.[9] When the relinquished property is transferred to a related party, a special two-year holding period takes effect. If either related party

[8] (1997) 109 TC 21, nonacq. 1999-35 IRB 314 as corrected by Announcement 99-116, 1999-52 IRC 763.
[9] Rev. Proc. 2002-83.

disposes of the property within the two years following the exchange, the deferred gain or loss will be recognized.[10] For this purpose, a related party includes family members, an individual and a corporation where that individual owns more than 50% of the stock, and an S corporation and any other corporation where the same persons own more than 50% of the stock.[11] While the related party rules are an additional hurdle, they can be seen as good news, in that it is clear exactly what the additional requirements are, in an objective measure.

Titling problems. Taxpayers should take particular care in acquiring or selling property as joint owners. Consider these situations –

> *For example*, Property A is traded away for Property B, each valued at $300,000. Property A was owned by the husband, but Property B is acquired jointly. The husband is considered to have acquired $150,000 of property as a replacement, so up to $150,000 of his gain on Property A is taxable.
>
> *For example,* Property C is traded away for Property D, each valued at $300,000. Property C was owned by the couple, but Property D is acquired by wife only. The husband is not considered to have acquired replacement property, so his entire gain is taxable.
>
> *For example,* Property E is traded away for Property F, each valued at $300,000. Property E was owned by the couple, but Property F is acquired by their family limited partnership. The entire gain is taxable as neither husband nor wife acquired replacement property.
>
> *For example,* consider the previous example with Properties E and F once again. Suppose it is the taxpayers' intent to contribute the replacement property into a family limited partnership. To avoid the negative outcome in the previous example, the couple acquired Property F jointly. After some time had passed, the couple contributed Property F to the family limited partnership. Was this like-kind exchange successful?
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>> As discussed earlier, we do not know how long either Property E or Property F must be "held" to qualify as a like-kind exchange. In this case, the IRS may argue that Property F was not held for business or investment use, as it was the taxpayers' intent all along to contribute the property to the family limited partnership[12]. As is the case in many tax issues, intent is important and should be carefully documented.

<u>Delayed or deferred exchanges.</u> In practice, rarely do two entities wish to evenly trade qualifying properties. More commonly, one of the parties prefers cash in a taxable transaction, or one party desires an exchange but the other party does not hold the type of property they want. In these cases, the Regulations provide that a delayed exchange is available.

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[10] IRC §1031(f).
[11] IRC §267(b).
[12] "Tax Deferred Exchanges of Property – Mistakes and Misconceptions", Gilbert F. Dukes, III. <u>Taxes</u> magazine, December 2001, pp 31-45.

> *For example,* A owns investment apartments, and B makes a generous offer that A feels he must accept. A would reinvest the profits, so a like-kind exchange is considered to shelter the gain. B would purchase the apartments with cash, and she does not own other like-kind property that A desires.
>
> One solution lies in a deferred exchange, where A transfers his property to a "qualified intermediary". The intermediary sells the property to B and holds the cash proceeds in escrow. A then selects suitable replacement property owned by C, and instructs the intermediary to purchase it with the escrowed funds. The replacement property is then acquired by the intermediary and subsequently transferred to A. For tax purposes, a three-way like-kind exchange has taken place for A.

There are many statutory requirements with a delayed exchange.

The qualified intermediary. A qualified intermediary is neither the taxpayer nor a "disqualified person", which is further defined as the taxpayer's agent, a related party of the taxpayer, or those who have acted as the taxpayer's accountant, attorney, employee, or broker during the prior two years, except for previous IRC §1031 exchanges or routine title, financial, or trust services performed by an institution.

There are practically no regulatory standards to call oneself a qualified intermediary. However, the taxpayer should consider the intermediary's real estate experience and bonding. We can certainly recommend one that we have worked with before. Also, the taxpayer can locate qualified

The escrow.

It is extremely important that the intermediary must hold the funds in escrow at all times. The taxpayer cannot hold the funds from the sale of his or her property, even momentarily. For this reason, a deferred exchange arrangement with a qualified intermediary and escrow account must be in place before any property transactions take place.

intermediaries in their area through a trade association, the Federation of Exchange Accommodators on the internet at www.1031.org.

The identification period. A taxpayer cannot use a delayed exchange to hold the proceeds from their sale indefinitely. The law imposes two time requirements, neither of which can be extended. Each of the time tests begin once the intermediary closes the initial sale, and the days can count before or after this date.

First, the replacement property must be identified to the intermediary within 45 days of the first sale. This directs the intermediary to begin the process of acquiring that property.

The importance of documenting the identification of replacement property cannot be overemphasized, as it is one of the areas that the IRS closely investigates when examining a deferred exchange. For this reason, the declaration should be in writing, with proof of delivery within the 45-day period. As further proof, we suggest that a copy of the declaration be included in our files.

One problem with the identification period is that once replacement property has been identified, and the 45-day period has expired, the seller of that property may decide not to sell. As stated above, no extension is available for the 45-day requirement, regardless of the reason. Therefore, it is wise to identify multiple replacement properties to the intermediary within the 45-day window, in case the primary property becomes unavailable.

The Regulations under IRC §1031 provide that the maximum number of replacement properties that can be identified is three, without regard as to their fair market values ("the three-property rule"). However, as long as the aggregate fair market of the selected replacement properties does not exceed 200% of the fair market value of the property transferred away, the number of identified properties is not limited ("the 200-percent rule"). Nevertheless, the 200-percent rule does not apply if the taxpayer acquires 95 percent of everything identified ("the 95-percent rule")[13]. If any of these identification rules are violated, then like-kind treatment is not available and all of the gain is currently taxable.

The identification of replacement properties must be specific[14]. If the replacement property is a condominium unit, the identification must specify a particular unit[15].

Further, the property acquired must be substantially the same as the property identified. For example, if a taxpayer identifies a specific property but acquires only a 50 percent interest in the property (perhaps a related party joint owner acquired the other 50 percent interest), then the property acquired is not substantially the same as the property identified. The Regulations state that the taxpayer must acquire at least 75 percent (in both size and value) of what was identified ("the 75-percent test")[16]. Therefore, if the taxpayer intends to acquire a partial interest in replacement property, the identification should make that point clear. If the taxpayer does not acquire the same degree of partial or whole ownership as identified, the taxpayer should take care to see that the 75-percent test is satisfied.

The acquisition period. The second time requirement is that the replacement property must actually be acquired by the intermediary within 180 days of the initial sale. Again, this time limit cannot be extended, so the taxpayer should use extreme caution when identifying replacement property that is not immediately available, such as a building under construction. In this situation, the taxpayer would lose like-kind treatment for something beyond his or her control, such as weather construction delays.

If the taxpayer is not careful, they may not receive benefit of the full 180-day period when an exchange is initiated late in the year. The 180-day rule actually states that the acquisition period ends on the *earlier of* 180 days from the original sale, or on the due date of the tax return for the first sale[17].

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[13] Regs. §1.1031(k)-1(c)(4)(ii).
[14] Regs. §1.1031(k)-1(c)(3).
[15] "Tax Deferred Exchanges of Property – Mistakes and Misconceptions", Gilbert F. Dukes, III. Taxes magazine, December 2001, pp 31-45.
[16] Regs. §1.1031(k)-1(d)(2), example 4. See also example 3 for comparison.
[17] Regs. §1.1031(k)-1(b)(2)(i).

> *For example,* the intermediary sells your property on December 1. You have until January 15 (45 days from December 1) to identify replacement property, and until May 30 (180 days from December 1 in a non-leap year) to actually acquire the property. Actually, this is calculation of the acquisition deadline is not absolutely correct, since the rule says that the acquisition period ends on the earlier of 180 days or the due date of the tax return. For individuals, the original sale on December 1 is reportable on the tax return due April 15 of the following year. As April 15 will appear before May 30 (the 180-day mark), April 15 becomes the deadline, effectively shortening the acquisition period from 180 days to 135 days.

The solution to this dilemma, where April 15 occurs before the 180 day expires, is that the tax return for that year should be extended so that the return due date is later than the 180-day expiration date.

If any replacement property is actually acquired in the 45-day identification period, it is deemed identified for purposes of that rule[18]. Further, any property acquired in the 45-day identification period counts toward the three-property rule and the 200-percent rule.

> *For example,* the intermediary sells Property A on May 1. On June 1, you acquire Property B. On June 14, you identify three replacement properties in writing to the intermediary. You have now violated the three-property rule since Property B counts as an identified property as well as the three properties identified on June 14. You will need to rely on either the 200-percent rule or the 95-percent rule to successfully complete the exchange[19].

Finally, the taxpayer should take care to make sure that they do not hinder their negotiating position due to their like-kind exchange situation. For example, if a taxpayer identifies Property A within the 45-day period, and the 45-day period has elapsed, the taxpayer should try to avoid disclosing the situation to the seller. f the seller is aware of the circumstances, the taxpayer has lost most or all of their negotiating leverage. The seller now knows that the buyer must now acquire this exact property within a limited time period, or else face unwanted tax consequences[20].

Boot. Because rarely do the two exchange properties have exactly the same value, cash or other non-like-kind property (known as "boot") is generally given to equalize the trade. This carries special tax significance in itself.

Boot paid. If a taxpayer invested additional funds in their property, no taxable event has occurred. Likewise, boot paid with the exchange, because the replacement property is more valuable, does not trigger taxable gain. The value of the boot paid is added to the basis of the relinquished property to determine the basis of the replacement property.

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[18] Regs. §1.1031(k)-1(c).
[19] "Tax Deferred Exchanges of Property – Mistakes and Misconceptions", Gilbert F. Dukes, III. Taxes magazine, December 2001, pp 31-45.
[20] Ibid.

Boot received. The receipt of boot, because the replacement property is less valuable, is treated as if the taxpayer partially sold the property (boot received) and partially exchanged the property (like-kind assets received). As a general rule, gain is recognized to the extent of boot received – see the prior discussion of the receipt of non-like-kind property.

For this reason, if the desired replacement property is less expensive, but a full deferral is preferred, the taxpayer should consider acquiring multiple replacement properties to increase the amount of their reinvestment.

One exception to the taxability of boot received is payments to you are considered to be applied first to the expenses of the exchange. Therefore, boot is taxable only to the extent it exceeds your expense of the exchange, including intermediary, legal, and brokerage fees.

Finally, note that a taxpayer might be in receipt of boot without actually receiving cash. Taxable cash boot can be either in the form of cash boot or mortgage boot. The law provides that if the taxpayer trades away property with associated debt (such as mortgaged real estate), the debt on the replacement property must be at least as large. In other words, if the taxpayer owes $800,000 on the replacement property when his or her debt on the original property was $1 million, the rules state that they are considered to have received $200,000 in boot which was used to retire debt. To prevent this outcome, make sure that your debt on the replacement property is at least as large as on the original property.

Advanced exchanges.

Reverse or "parking" exchange. Frequently, a taxpayer may find an irresistible investment opportunity, but their own property which would be exchanged is not yet on the market. The obvious solution is to entice the owner of the other property to delay a sale until the taxpayer can sell their original property first. In the real world, however, most real estate is on the market to be sold as quickly as possible.

In a parking exchange, the taxpayer employs a qualified intermediary to set up a new entity that is unrelated to the taxpayer, probably an LLC with at least two members. This unrelated entity acquires the new property and holds it until the taxpayer has sold his property and is ready to accept the new property as its like-kind replacement property.

It is important to note that this new entity will sell the property to the taxpayer in a transaction that is fully taxable if a gain, but a loss may not be allowable. Therefore, any appreciation that is realized while the new entity holds the property will be taxed, perhaps at short-term capital gains rates. However, in reality, the transaction costs relating to transferring this property twice will frequently exceed any appreciation during the "park".[21]

Finally, note that in September of 2000, the IRS issued Revenue Procedure 2000-37[22] which provides a "safe harbor" reverse exchange mechanism. A safe harbor procedure means that if the taxpayer follows all of the rules as given by the IRS in this Procedure, he or she can be assured that the exchange

[21] See, for example, *Coastal Terminals, Inc. v. U.S.*, (1964, CA4) 12 AFTR 2d 5247.
[22] Rev. Proc. 2000-37, IRB 2000-40, 308.

will qualify upon examination. However, the standards given in the Procedure are somewhat rigid, and some taxpayers may decide that some of the tests cannot be satisfied based on the facts at hand.

For those, the Procedure notes that this safe harbor is one way to satisfactorily accomplish a reverse exchange, but is not necessary the only way to do it.

Construction exchanges.

Sometimes, the taxpayer will have trouble locating adequate replacement property in their preferred geographic area at the cost necessary to defer the gain in question. The answer for this dilemma may require building the replacement property. This choice sometimes creates problems of its own, notably that the cost of the unimproved lot is not sufficient to shelter the current gain.

In this type of exchange, the qualified intermediary creates a new, unrelated entity such as described above for the parking exchange. In this example though, the new entity acquires the undeveloped lot and contracts for construction. When the construction is complete, the new entity completes a taxable transfer to the taxpayer.

The inherent problem with a construction exchange is the replacement period rule. It may be difficult for the taxpayer to have this new entity acquire the land and build the replacement structure within the required 180-day acquisition period. The taxpayer must be careful to see that construction will be complete within the required time period, or face the non-tax issues of the transfer at a stage of incomplete construction. A local real estate attorney should be consulted if a construction exchange is the plan of action to ensure that the sale of incomplete property can be done if needed.

***Reverse construction exchange*.** This situation is essentially a combination of the prior two, and may be the solution when construction is expected to take more than 180 days. Simply put, the new, unrelated entity established by the qualified intermediary would purchase the unimproved estate and begin construction *before* the current property is sold. When the taxpayer is confident that construction will be complete within a 180 day window, the current property is offered for sale. Of course, this strategy carries the potential acquisition period problems of unexpected construction delays and difficulties in selling the current property.

***General comment on these advance exchanges*.** Taxpayers should be aware that these are complex transactions that are much more likely to bring governmental scrutiny. Specific research should be conducted to ensure that the facts at hand will fall under the precedents established by case law. Also, taxpayers may have difficulty finding qualified intermediaries that are willing to enter into these types of transactions. The taxpayer should expect that intermediaries that accept these additional responsibilities will charge premium fees for their services.

Conclusion.

A like-kind exchange is an excellent vehicle for reinvesting profits on business on investment property. As this discussion shows, the transaction can be quite complex. Also, the nuances and fine print of the requirements are firm, and cannot be extended. Therefore, careful planning is required in advance of any anticipated exchange transaction.

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