

A photograph of a sailboat with a large white sail on a blue sea under a clear sky. The sailboat is white with a dark stripe along the hull. The water is dark blue with some white foam from the boat's wake. The sky is a clear, bright blue. The sail is fully deployed and billowing. The boat is moving from left to right across the frame.

TAX-FREE EXCHANGES

Powerful Ideas: Deferring Tax upon the Disposition of Real Estate

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Deferring Tax Upon the Disposition of Real Estate

Like-Kind Exchanges – In General

A taxpayer that sells real estate must generally pay taxes on any gain resulting from the transfer. However, a like-kind exchange pursuant to Internal Revenue Code (IRC) §1031 allows a taxpayer to defer recognizing the gain on a sale of real estate because the real estate received in exchange is considered of a like-kind. In other words, a like-kind exchange generally allows the owner of one piece of real estate to exchange that real estate for one or more similar pieces of real estate without recognizing income taxes on the exchange. Instead of gain being recognized, the basis of the property (or properties) received will be the same as the property transferred. This defers income taxes until the newly received property is sold at some point in the future.

How Do Like-Kind Exchanges Work?

In order to qualify for a like-kind exchange, real estate must be exchanged for other real estate, however, the quality of the real estate need not be the same. This means that a skyscraper in New York City (fully developed real estate) may be exchanged for undeveloped land in Vermont. In addition, the real estate has to be used in a trade or business or held for investment. Therefore, real estate held for personal use, such as a residence or vacation home, cannot qualify for like-kind exchange treatment.

As noted above, like-kind exchanges will generally be tax-free. However, if cash or other property (referred to as boot) is received, gain will be recognized to the extent of the lesser of the boot or any gain recognized on the transfer.

Lastly, transactions between related parties are subject to IRC §1031(f) which states that if either party in the exchange transfers the property received within 2 years of the exchange, they will recognize the gain or loss in the transaction in the year it's transferred.

The Regulations under IRC §1031 allow for deferred exchanges. A deferred exchange occurs when a property is transferred before a replacement property has been chosen. In order to facilitate a deferred transaction, a qualified intermediary is generally used. 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 fair market value of the exchanged property; or
- Identify any number of replacement properties so long as the fair market value of the properties actually received at the end of the exchange period is 95% of the aggregate fair market value of all properties identified.

Lastly, (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.

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.

The IRS requires that Form 8824, Like Kind Exchanges, must be filed with the appropriate return. Form 8824 requires the transferor to list the description of the properties, the dates the properties were transferred between parties, and the dates of identification of the properties.



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