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Tax Watch

## Review the Fundamentals of Section 1031 Like-Kind Exchanges

by *Thayne Needles*

**T**axpayers planning to sell, purchase, or construct real property should review the possibility of conducting an Internal Revenue Code Section 1031 like-kind exchange to defer the incurrence of federal and general state income taxes on the capital gain. To qualify, property owners must exchange real or personal property (relinquished property) for other property of a like-kind (replacement property).

For example, Javier Cortez owns an apartment building valued at \$500,000. He wants to sell the building to purchase another investment property but avoid incurring capital gains taxes. Following detailed IRC rules, he can accomplish this through a 1031 exchange.

### Defining Like-Kind Property

The definition of like-kind real property is very broad; the replacement property does not have to be the same type as the relinquished property. For example, Javier could exchange his multifamily building for an office or retail property or for a tenancy-in-common or fee interest. Also, the replacement property is not limited to a single building; Javier could purchase a portfolio of three small buildings.

Personal property may be exchanged for other like-kind or like-class property, but the definition of like-kind personal property is more restrictive than that applied to real property. For example, the exchange of a truck for a car likely would not be allowed, while the exchange of one car for another car or a computer for a printer is treated as an exchange of like-kind property.

Real property is not like-kind to personal property, but combinations of the two may qualify under Section 1031 rules. For instance, Javier could not exchange his multifamily building and its furnishings solely for real or personal property in a completely tax-free exchange, but he could exchange the property for a combination of real and personal property, such as a restaurant and its furnishings and equipment. However, exchanges involving both real and personal property may result in the recognition of some gain as it is unlikely that equal values of personal property of a like-kind are exchanged. This form of multiple property exchange is subject to specific rules and can result in the recognition of gain even in the absence of any money transfer.

Not allowed are transfers of certain property inventory or other property held primarily for sale, such as subdivided lots held for sale, and interests in partnerships or real estate investment trusts.

### Use Requirements and Holding Period

Taxpayers must have held the relinquished property for use in a trade or business or for investment. Under this requirement, personal residences are not eligible. Vacation homes may qualify as investment property if the taxpayer's personal use is limited or the home has been rented. Since Javier's multifamily building is an investment property, it is eligible for an exchange so long as he selects a replacement property to hold as an investment.

While no formal rule exists, the Internal Revenue Service historically has taken the position that the taxpayer must hold both the relinquished and replacement properties in a qualified use for a certain time period. Thus, the IRS might challenge the exchange if Javier sold the replacement property shortly after the exchange. Taxpayers should consult with a tax adviser concerning the appropriate holding period for property.

### Recognition of Gain or Loss

To defer total gain, both the value and net equity of the taxpayer's replacement property must equal or be greater than the value and net equity of the relinquished property at the time of the exchange. In Javier's case, the replacement property must have a value of at least \$500,000 and the value must exceed by \$300,000 (net equity) any debt assumed in connection with the replacement property.

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If the value of the replacement property is less than \$500,000 or the net equity is less than \$300,000, Javier would be taxed on the greater of the trade down in value or equity, limited to the gain he would have recognized if the property simply had been sold for its fair market value.

### **The Qualified Intermediary**

Most like-kind exchanges are deferred exchanges. To complete a deferred exchange, the taxpayer must transfer the relinquished property for other like-kind property and not for money. Therefore, the taxpayer cannot gain actual or constructive receipt of the relinquished property's proceeds before purchasing the qualifying replacement property. Tax regulations impose strict limitations on the taxpayer's access or control over the proceeds and expressly limit the right to receive, pledge, borrow, or otherwise obtain the benefits of the money.

Thus, deferred exchanges require the use of a qualified intermediary to hold the sale proceeds and acquire the replacement property. Certain persons that provide other services on behalf of the taxpayer are disqualified to act as a qualified intermediary. Many companies specialize in acting as a qualified intermediary for a fee. Consult a tax adviser to make certain that a qualified person is acting as the intermediary in the case of a deferred exchange.

For example, Javier chooses an acquaintance, Robert, as the qualified intermediary. He assigns his rights under the relinquished property sales agreement to Robert who holds the sale proceeds in an account or in a qualifying escrow until purchasing the replacement property on Javier's behalf.

### **Deferred Exchange Timing**

Strict timing rules apply to deferred exchanges. Generally, the taxpayer must identify the replacement property or properties in writing to the intermediary within 45 days of the relinquished property's sale. Within 180 days of the transfer of the relinquished property, the taxpayer must receive the replacement property. The 180-day period is limited to the due date of the taxpayer's tax return unless that return is extended.

Tax rules also place restrictions on the taxpayer's right to use or pledge the relinquished property sale proceeds during the 180-day exchange period. In Javier's situation, he sold the multifamily property to another investor for \$500,000 and placed the proceeds in an escrow account held by Robert. Within a month he identified in writing two small medical office buildings as the replacement property. Two weeks later, Robert purchased the medical office buildings for \$500,000 using the relinquished property sale proceeds and transferred the title to Javier. By following the guidelines, Javier successfully completed a deferred exchange and avoided incurring federal and state taxes.

Consult a tax professional for more information about Section 1031 tax-deferred exchanges.

