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Top Ten Questions about Like-Kind Exchanges

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Like-kind exchanges are a popular tax deferral device governed by §1031 of the Internal Revenue Code. However, care must be taken to meet the statutory and regulatory requirements to achieve tax deferral. Below are some of the most common questions we encounter with respect to like-kind exchanges.

1. What are the elements of a like-kind exchange?

- A taxpayer (the same taxpayer before and after the exchange)
- Exchanges property
- Held (for how long?)
- For productive use in trade or business or for investment
- For like-kind property also to be held for productive use in a trade or business or for investment (no personal residences)

2. How does a §1031 exchange benefit a taxpayer?
A §1031 exchange defers taxable gain on the disposition of the relinquished property and in turn reduces the taxpayer's basis in the replacement property.

Note that gain is recognized to the extent boot (cash or non-like-kind property) is received. There is no division of basis between the like-kind property and the boot.

3. If I reinvest the net proceeds of the sale of my relinquished property, I will defer all my gain under §1031, right?
No. In order to defer all the gain from the disposition of property, (a) an exchange must occur (not a sale and reinvestment), and (b) the taxpayer must trade up or at an equal level in both value and equity.

4. How long must I have held my relinquished property before the exchange? How long must I hold the replacement property after an exchange?
No bright line holding period exists. Time is only one factor in determining investment intent.

5. How much development activity will change my property from property held for investment to property held for sale (i.e., inventory ineligible for §1031 treatment)?
Investment determination is made at time of exchange, not time of acquisition. Activities such as subdividing, putting in roads and utilities, and advertising the property for sale make the property likely to be treated as inventory.

6. Can I take cash out of my property by refinancing before an exchange? How about after an exchange?
The issue is whether the proceeds from the refinancing can be recharacterized by the IRS as boot in the exchange.

Most authorities advise against refinancing prior to an exchange except in extraordinary circumstances (where a substantial business purpose exists). However, refinancing after an exchange is considered relatively safe.

7. Can I exchange improved property for unimproved property and vice versa? What about personal property (e.g., an airplane)?
Real property of almost any type will be considered like-kind to other real property. Personal property is subject to much tighter rules.

8. What steps are needed for a deferred exchange?

- Enter into an Exchange Agreement with a qualified intermediary (QI).
- Place net proceeds of sale of relinquished property with QI.
- Within 45 days of date of sale, identity replacement property in writing using the three property/ 200% of value tests.
- Within 180 days of date of sale, or, if earlier, the due date of the taxpayer's return (including extensions), close on the replacement property.
- Make certain to follow the assignment/notice provisions of the deferred exchange regulations.

9. What is a reverse exchange? How do I do one?
A reverse exchange is really a parking arrangement. In most cases replacement property is parked with an Exchange Accommodation Titleholder until the time that the relinquished property can be sold. Revenue Procedure 2000-37 gives the safe harbor procedures.

10. My partners do not all want to participate in an exchange. Now what?
Possible solutions:

- Use some cash from sale of relinquished property to redeem cash-out partners.
- Distribute an undivided interest in the property to the cash-out partner prior to sale.
- Sell in part for an installment note; distribute the note to the cash-out partners.

11. Bonus Question: Can I buy my replacement property from a related entity?
No, in Revenue Procedure 2002-83 the IRS recharacterized a purchase of replacement property from a related party as first an exchange with the related party followed by a sale of property by the related party. A sale by the related party in these circumstances violates the statutory rules for related party exchanges.

Many more issues can arise in constructing like-kind exchange transactions and there are many IRS rulings and court cases interpreting the various rules. Make certain you properly structure your like-kind exchange by consulting with your attorney before you begin.