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1031: A Like-Kind Exchange

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Like-Kind Exchange

What is it?

As a general rule, immediate tax liability will not result from a like-kind exchange under Internal Revenue Code Section 1031. A like-kind exchange occurs when appreciated property held for productive use in a trade or business (or for investment) is exchanged for like-kind property that will be held for productive use in a trade or business (or for investment). However, when property in addition to the qualifying property is received in a like-kind exchange, there may be partial taxability. See Questions & Answers.

Tax-deferred exchanges may be useful if you have property that may be difficult to sell. Tax-deferred exchanges may also be useful if you are locked into a piece of property because the property has declined in value. In either of these instances, it may be easier to exchange the property with an investor who can wait to realize its potential. Tax-deferred exchanges will also be useful if you have highly appreciated property and cannot afford to pay the tax on the sale. Since it is possible to convert nondepreciable basis property (e.g. unimproved land) to depreciable basis property (e.g. improved real property), and vice versa, you should do some careful tax planning to determine when a like-kind exchange can and should be used.

When can it be used?

The property that is exchanged must be of a like-kind

The first requirement of a like-kind exchange is that the property to be exchanged must be of a like-kind. The definition of like-kind property has generally been liberally construed. Like-kind property is defined as relating to the nature or character of the property, rather than to its grade or quality. Like-kind does not mean the properties need to be identical. Real property may be exchanged for other real property, and personal property may be exchanged for other personal property. Two or more qualifying properties may be exchanged for like-kind property.

Like-kind real property

Most exchanges of real property qualify as like-kind exchanges because they are, by nature, characteristically similar. Whether either or both parcels are improved or unimproved, the exchange will be deemed like-kind because improvements to property relate to the grade or quality, and not to the type or class. The Internal Revenue Service (IRS) has consistently found, however, that a real estate improvement, such as an office condominium, is not like-kind with either improved or unimproved real property. Some federal circuit courts have taken a different view than the IRS on this issue.

Some examples of like-kind real property include improved land (i.e., with appurtenant buildings or other structures), unimproved land, a mineral interest in land, timberland or a farm. Leases of 30 years or more are considered to be like-kind with other real property. Also, water rights, air rights and mineral rights may qualify as like-kind real property, depending on your state law. A life interest in real property, as well as a remainder interest, may each be considered like-kind property, which may be exchanged for similar interests in real property. However, characterizing these interests as like-kind will also depend on whether your state law considers these interests to be real property interests. It is important to note that an exchange of a remainder interest in real property for a life interest in real property would be considered rental income rather than a like-kind exchange. Finally, foreign real property is not like-kind when exchanged for U.S. real property.

Like-kind personal property

Personal properties are generally deemed like-kind if they are similar in nature or class. Items of depreciable personal property are of the same class if they are within the same general business class or of the same product class. This means that a computer may be exchanged for a computer printer and a washer may be exchanged for a dryer. Only depreciable tangible personal property is considered to qualify as like-kind personal property.

Nondepreciable tangible personal property (e.g. jewelry) and intangible personal property (e.g. patents) do not qualify as like-kind personal property. Goodwill and going concern value cannot qualify as like-kind personal property. The IRS assigns product codes to depreciable tangible personal property. Before exchanging such property, a tax attorney or accountant should be consulted.

The property you exchange and acquire must be held by you for productive use in a trade or business, or for investment

The second characteristic of a like-kind exchange is that both the asset you exchange and the asset you receive must be held for productive use in a trade or business, or for investment. The word "held" seems to be the operative word for determining if this requirement is met. There is no rule (except as to related parties, which is discussed below) as to how long you must hold property received in a like-kind exchange before you may then sell or transfer the property and still meet this requirement. The IRS will look closely to determine whether you had the intention of selling the property acquired in the exchange at the time of the exchange. This is not to suggest that a general intention to make a future transfer of the property acquired will not be allowed. As an example, if you eventually contemplate transferring property to your children, but have not formed an actual plan to do so at the time of the exchange, you may be able to meet this requirement. However, it is clear the IRS will also consider the immediacy of any resale or transfer of property acquired by you in determining whether such property acquired is held for business or investment use. There is no such requirement that the other party must hold the property received in the exchange for productive use in a trade or business, or for investment.

There must be an exchange, rather than a sale and separate purchase

The third characteristic of a like-kind exchange is that there must be an exchange of the like-kind property, rather than a sale and a separate purchase. In determining whether a transaction is a sale or exchange, the substance of the transaction will prevail over the form of the transaction. An exchange is typically thought of as a reciprocal transfer where the property received is of equal value to the property given away. The IRS will look to the timing of the transaction as well as the intent of the parties and whether the transactions are dependent upon each other. Questions most often arise in what the IRS refers to as "step transactions," or transactions in which an independent sale and purchase are so closely related that they are, in reality, one transaction.

Strengths

Appreciated property may be exchanged for other property without immediate tax consequences

The advantage of not having to pay an immediate tax bill is somewhat self-explanatory. While gain from a sale could be spread out over numerous years by using the installment sale provisions, the net amount you would be able to reinvest would still be diminished. The Internal Revenue Service (IRS) allows you to defer your recognition of gain in a like-kind exchange because it realizes that you will eventually recognize gain or loss from any later sale of the replacement property.

Tax-deferred exchanges of business or investment property are not limited to exchanges between two parties

The IRS allows like-kind exchanges to occur between two or more parties. The IRS does recognize that two property owners may not often agree that each other's property will be acceptable in an outright trade.

Two-party exchanges

A two-party exchange is virtually self-explanatory. There are two parties to this type of transaction, and you will each exchange your respective properties. The property you receive must then be used by you in a trade or business or for investment. The property exchanged must be of a like-kind.

Three-party exchange

The three-party exchange is a tax-driven exchange designed to solve the dilemma occurring when the owner of the property that you seek wants to sell the property for cash, rather than trade the property. There are several types of three-party exchanges that may qualify as like-kind exchanges. In a unilateral transfer, you will transfer

property to the purchaser, the purchaser will transfer cash to the seller, and the seller will transfer the seller's property to you. A bilateral exchange with the seller occurs where you and the seller exchange your respective properties and then the purchaser buys your former property from the seller. Another arrangement, a bilateral exchange with the purchaser, occurs when the purchaser buys the seller's property for cash, and then exchanges the seller's former property with your property. These three-party transactions seem to be of concern to the IRS, and the service may (1) look closely at the transaction to determine whose funds are actually being used to acquire ownership, (2) examine whether you in any way "received" the cash or had the right to control the cash, and (3) determine whether an exchange, rather than a sale, was intended.

The exchange does not have to be done simultaneously, as long as replacement property is identified and actually received within a certain time period

A two-party or three-party like-kind exchange may occur either simultaneously or in a deferred manner. Simultaneous like-kind exchanges occur when your like-kind property is relinquished and exchanged, at the same time, with other like-kind property.

Deferred exchanges

Deferred exchanges occur when you do not receive your replacement property at the same time you relinquish your property. There are additional rules for exchanges that occur in a deferred manner. A deferred exchange may still qualify as a like-kind exchange if certain requirements are met. Because the IRS realizes it may be difficult for you to find replacement property which can be simultaneously exchanged, the IRS will allow you to receive replacement after the relinquished property has been transferred. However, you must identify replacement property within 45 days after the relinquished property is transferred, and you must actually receive the replacement property within 180 days (or, if earlier, by the due date (including extensions) of your return for the tax year in which the property was transferred). You may identify more than one replacement property to increase the likelihood of meeting the requirements of the deferred exchange rules. However, if you identify more than one replacement property, you must meet either the 200 percent rule or the three-property rule. Under the 200 percent rule, the aggregate value of all of the identified replacement properties cannot exceed 200 percent of the value of the relinquished property. The three-property rule allows you to identify a maximum of three properties, without regard to their value.

Tradeoffs

The exchange provisions apply to both gains and losses

The fact that the exchange provisions apply to both gains and losses means that you should review your tax objectives when you dispose of a piece of property. You may want to opt for a taxable transaction if you have the availability of a loss carryover from a prior year, or have significant losses in the year of the transaction that would offset any gain from the sale of the property.

The exchange provisions become mandatory if all of the requirements are met

You will not be able to treat your transaction as taxable if it meets all of the requirements of a nontaxable transaction.

Gain or loss will be recognized in an exchange between related parties if either the property transferred or the property received is disposed of within two years after the exchange

If you exchange property with a related party, the related party must hold the property for two years before any sale is made by that party, or else the Internal Revenue Service will deem the entire transaction to be a sale and separate purchase and thus taxable to you. Any gain or loss which you did not recognize on the original exchange will be recognized on the date the like-kind property is disposed of either by you or the related party. These rules are somewhat strict, in order to prevent the use of the like-kind exchange rules to shift gains from a higher tax bracket taxpayer to a related lower tax bracket taxpayer. Exceptions to the related party rule exist where neither the original exchange nor the subsequent disposition were done to avoid federal tax, or the disposition was due to the death of the related party or some involuntary conversion of the property.

How to do it

Review requirements

You will need property held for productive use in a trade or business or for investment. In addition, remember the following:

- You will need to identify like-kind replacement property
- You will need to exchange your property for like-kind property
- You must hold your replacement property for productive use in a trade or business or for investment
- You should consult your accountant or tax attorney to assist you in any like-kind exchange

Tax considerations

Income Tax

Deferral of Income

Like-kind exchanges are really a tool utilized for purposes of deferring the recognition of income. If done properly, no income tax should result from a like-kind exchange. Note that depreciation recapture, however, may be an issue.

Gift and Estate Tax

Estates can be treated as related parties under the like-kind exchange rules

Gain or loss will be recognized in an exchange between related parties if either the property transferred or the property received is disposed of within two years after the exchange

Questions & Answers

Does it matter who finds the replacement property in a like-kind exchange?

The Internal Revenue Service does not consider it relevant which party to the transaction actually seeks out or finds the replacement property.

Can the parties enter into an option to purchase for cash without defeating the tax-free exchange?

Yes. This most typically occurs if a three-party agreement is entered into without replacement property first being identified. The parties may enter into an option to purchase for cash, which, if the option eventually goes unexercised, will not defeat the tax-free exchange.

What if you receive money or other property in addition to the replacement property?

An exchange may require the receipt of money or other property in order to equalize the value of the properties being exchanged. Such additional assets are typically referred to as "boot" and may be taxable to you if there is gain on the exchange. Boot may be in the form of cash, notes, relief from mortgages or other debt, or personal property. When boot is included in the transaction, gain is recognized, but not in excess of the sum of cash and the fair market value of the other non-like-kind property.

Example(s): If you exchange real property with a basis of \$20,000 for like-kind real property with a

fair market value of \$30,000 plus \$10,000 in cash, the gain on the exchange is \$20,000. However, the gain is recognized only to the extent of the cash received, \$10,000. Since relief from debt is also considered boot, if liabilities are assumed by both parties in a like-kind exchange, the liabilities will be netted to determine the amount of boot. The receipt of boot will never result in the recognition of loss.

How do you determine the basis of the property you receive in a like-kind exchange?

It is still necessary to compute the tax basis of property received in a like-kind exchange for purposes of computing depreciation on the property and for determining gain or loss when the property is sold in the future. Computing the tax basis of the property may become particularly difficult where boot is received or where mortgages or other liabilities are assumed or paid. When no boot is given up or received in a like-kind exchange, the basis of the property received is the same as the basis of the property transferred. The expenses incurred in the exchange may also be added to the basis. If cash or other nonqualifying property is exchanged in addition to the qualifying property, the basis of the property acquired is the basis of the property transferred plus the fair market value of the nonqualifying property transferred. When an exchangor transfers property subject to a mortgage for mortgage-free property, the amount of the outstanding mortgage is treated as boot received by the exchangor. The basis of the property received in the exchange is increased by the amount of any mortgage assumed in the exchange.

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