Like-Kind Exchanges

1031 Exchange

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A like-kind exchange, or 1031 exchange as it is often referred, is a tax-deferred exchange of one property for another property of a like-kind. While this exchange is often referred to as "tax-free" exchange, it does not actually help the taxpayer avoid the tax entirely, it simply affords the luxury of deferring the potential tax that would be due until the time at which the replacement property is disposed. The Internal Revenue Code under §1031(a)(1) states:

> *"No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like-kind which is to be held either for productive use in a trade or business or for investment."*

At first glance, this seems to be a simple concept that would not be very useful in most situations. After all, if you have property that you would like to exchange for another property, what is the likelihood that the other property owner wants your property? This is where the Qualified Intermediary comes into play.

Qualified Intermediary - The regulations under §1031 allow the use of a third party to help facilitate the exchange. This third party is referred to as a Qualified Intermediary. The qualified intermediary effectively acts as a conduit to take your property and exchange it for the replacement property that you wish to acquire. This removes the necessity to actually have two property owners exchange properties with each other.

Example. John owns land with standing timber on it that is valued at $300,000. His land has basis of $50,000 and the timber has zero basis. He wishes to exchange his property for Sarah's property. Sarah owns raw land valued at $300,000. However, Sarah does not want John's property. Steven, on the other hand, would very much like to buy John's property. John can utilize a qualified intermediary to make the exchange work as follows: Steven purchases John's property for $300,000 and the intermediary receives the proceeds. The intermediary takes the proceeds and purchases the land from Sarah on John's behalf. For tax purposes it is treated as if John exchanged his property for Sarah's in a tax-deferred exchange.

While this seemed very simple in the previous example, in practice there are many rules and regulations surrounding the use of an intermediary that should be held in high regard, and closely followed, to ensure that the exchange will be properly treated as tax-deferred. However, it should be noted that a qualified intermediary makes it possible for a property owner to exchange his or her property for any other like-kind property without having to find another property owner who wishes to receive his or her property in exchange.

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Like-Kind Property - Under the §1031 exchange rules, the definition of property is very broad. It includes both real property, such as land or other real estate, and personal property, such as machinery or equipment. It also includes tangible property, such as a barn or a tractor, and intangible property, such as a copyright or a patent. The important qualifying factor when exchanging property is to ensure that both properties are considered like-kind. Like-kind refers not to the quality of the property, but more so to the nature or class of the property. For instance, personal property can only be exchanged for personal property. Likewise, real property may only be exchanged for other real property. Real property may not be exchanged for personal property, and vice versa. While these are both considered property, they are not of the same nature or class. With respect to timber transactions, standing timber sold as part of a timberland tract is considered real property, but cut timber is considered personal property for these rules.

For real property exchanges, the like-kind rules are rather relaxed. As long as the exchange is real property for real property and both the property given up by the taxpayer and the new property received are held, or to be held, for business or investment, then it will typically qualify. For example, improved real estate may be exchanged for unimproved real estate. Real estate in the city may be exchanged for farm land or ranch property. Land with standing timber may be exchanged for raw land. It should be noted that real property does not just mean real estate. It could also be a mineral interest, a remainder interest, a life estate in real property or a lease of 30 years or more. However, the like-kind rules pertaining to these other types of real property become more stringent and require additional oversight.

For personal property exchanges of business use property, the like-kind rules are much more rigid. The like-kind rules for personal property exchanges of tangible investment property and intangible property have an even narrower window of qualification. For example, while patents on different processes potentially qualify as "like-kind" property, Revenue Ruling 82-166 held that an exchange of gold bullion for silver bullion does not. For these reasons, personal property exchanges generally should to be looked into on a case by case basis.

The Exchange Process - Once established that the properties will qualify as like-kind to each other, the tax deferral will work as follows. If you are exchanging property for property, and the values are equal, then you will recognize no gain in the transaction. Your basis in your old property will become your basis in your new property.

If the properties are not equal in value, which is typically the case, then there will be cash or other property involved to even the transaction out. This cash or other property is referred to as "boot". The relief of your debt on your property is also treated as boot received. Likewise, if the property you receive is subject to debt that you are taking on, then it is treated as boot paid. If "boot" is involved, you will typically have to recognize gain to the extent of the net amount of boot you receive. Your basis in your new property will be reduced by the boot received, but increased by the gain realized as a result. If you provide boot to the other party, then the basis in your property will be increased by that same amount.

Example. John exchanges timberland with a basis of $50,000 for a raw land valued at $270,000 plus $30,000 in cash. John's gain on the exchange is $250,000: he received $300,000 in value for an asset with a basis of $50,000. However, since it's a like-kind exchange, he only has to recognize $30,000 of his gain: the amount of cash (boot) he received. John's basis in his new land will be $50,000: his original basis in the land he gave up ($50,000) plus the $30,000 gain recognized, minus the $30,000 boot received.

In closing, a like-kind exchange is a powerful tool that can be used in many circumstances to transfer from one investment to another without having to cash out your profit in the investment. The rules are stringent, and must be properly followed, but with the right structuring a like-kind exchange can result in an exchange of property with a complete deferral of taxes.

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