Build Wealth with a Like-Kind Exchange

Presented By:

Mat Whited

Tax Manager

513.338.8259

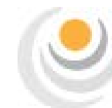
mbwhited@cshco.com

Chris Michel

Tax Senior

513.746.2791

camichel@cshco.com



Learning Objectives

- General rules for like-kind exchanges
- Gain computation, basis, and depreciation
- Other exchange requirements
- The qualified intermediary
- Examples

The Basic Rule of Selling Property

- **The basic rule** – gain or loss is recognized upon a sale or exchange of property – § 1001

- **The exception to the rule** – gain or loss is not recognized if property held for productive use in a trade or business or investment is exchanged for property of like-kind to be held either for productive use in a trade or business or investment.
  - However, gain must be recognized to the extent that any money or non-qualifying property is received - § 1031(a) & §1.1031(a)-1(A)

The Many Names for a Like-Kind Exchange

- Starker exchange
  - Named from Starker v. U.S. (602 F.2d 1341)
- "Tax-free" exchange
  - "Tax-free, for now" would be more fitting
- Deferred exchange
- 1031 exchange
  - Named from the respective IRC section

The General Rules of Like-Kind Exchanges

- To qualify for non-recognition of gain under §1031, relinquished property must be exchanged for replacement property of "like-kind" for investment or use in trade or business

- In other words, three requirements must be met:
  1. The exchanged properties must be of "like-kind" to each other
  2. The property must be held for investment, or use in a trade or business
  3. There must be an "exchange" of properties

The Exchanged Properties Must Be of "Like-Kind" to Each Other

- Property is of like-kind if it is of the same nature or character - §1.1031(a)-1(b) & (c)
  - Does not refer to the grade or quality (i.e., an old vs. a new building)
- Depreciable tangible personal properties are of like-kind if within same general asset class or same product class, and otherwise like-kind
- Intangible personal property must consider the nature or character of rights involved and the nature or character of underlying property

The Exchanged Properties Must Be of “Like-Kind” to Each Other

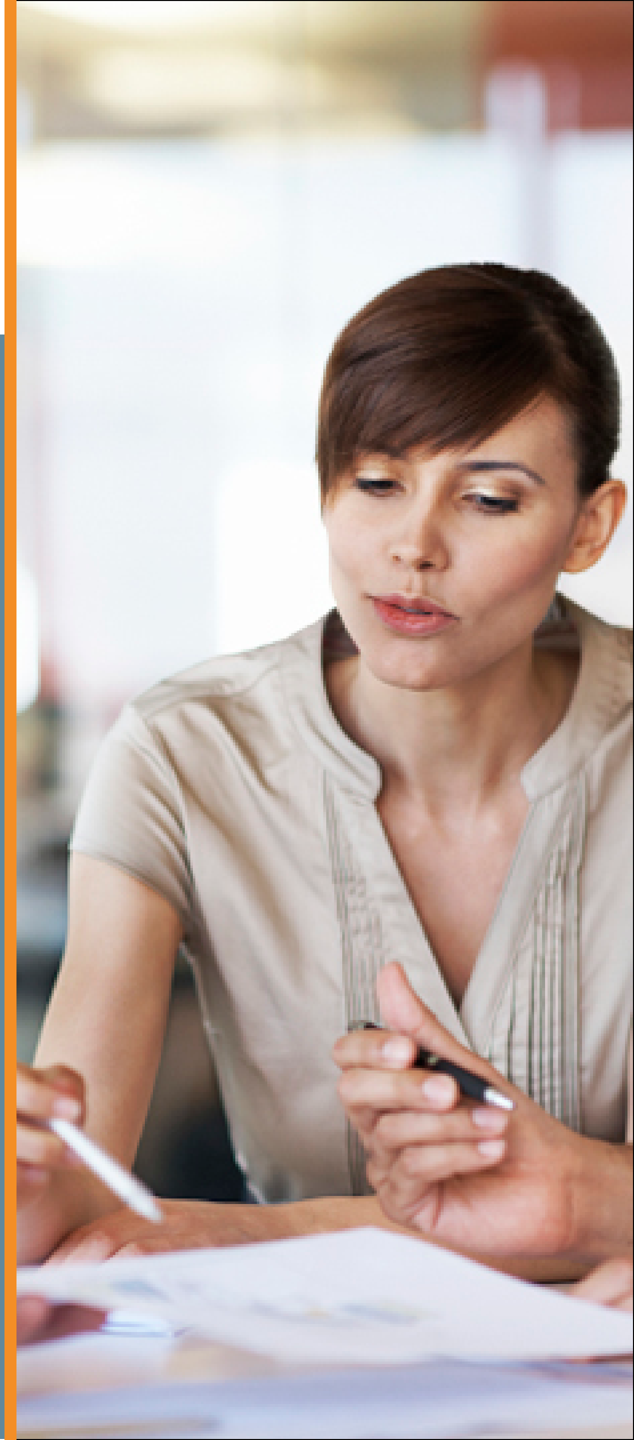
- Most types of real estate are of a like-kind
  - A lot with a building located in the city is of like-kind to farm land
  - Land and improved real property (such as an office building) are like-kind
  - Leasehold interests in real property greater than 30 years (including renewals) is like-kind with other real property
  - A couple catches:
    - Real property located inside the U.S. and real property located outside the U.S. are not of like-kind
    - Land-only real property is not like kind with building-only real property (Rev. Rul. 67-255)

The Property Must Be Held for Investment, or Use In a Trade or Business

- Taxpayer must hold relinquished and replacement properties for "productive use in a trade or business, or for investment"
  - Intent is tested at the time of the exchange
  - Watch for nontaxable transfers (§§721, 731, 351) before or after exchange
  - Personal-use property does not satisfy requirement - Rev. Proc. 2008-16
  - Same taxpayer must initiate/start and complete the exchange

Property Excluded from §1031 Treatment

- Property excluded from §1031 treatment
  - Inventory or other "property held primarily for sale"
  - Stock, bonds, notes
  - Other securities or evidences of indebtedness
  - Interests in a partnership
  - Shares of a corporation
  - Certificates of trust or beneficial interests
  - Certain tax-exempt use property



Related Party Like-Kind Exchanges

- Generally, gain in a like-kind exchange with a related party (related directly or indirectly) is triggered if either person disposes of exchanged property within two years

- Generally, taxpayer may not acquire replacement property (through a QI) from a related person if it results in "basis shifting"
  - The exception to this is if the related party is acquiring replacement property to complete its own exchange

There Must Be an “Exchange” of Properties

- Three general types of exchanges:

1. “Forward” or deferred exchange - §1031(a)(3)
   - 45-day identification requirement
   - 180-day closing requirement
   - Usually structured through a QI for safe-harbor treatment (explained later)

2. Simultaneous exchange

3. “Reverse” exchange
   - No IRC authority, relies on Rev. Proc. 2000-37 for safe-harbor treatment

Gain Computation

- Taxpayer must trade equal or up in both FMV and equity to defer all gain
- Boot – money or property not of a like-kind (non-qualifying property) that is received by a taxpayer as part of a like-kind exchange
- Gain realized is recognized only to the extent of cash or the FMV of other non-qualifying property received (i.e., boot)
  - Relief of liabilities treated as money received but may be offset by liabilities assumed and cash paid in the exchange

Basis and Depreciation

- Basis – generally, the replacement property takes the substituted basis. In other words, the basis in relinquished property rolls over into the replacement property, with certain adjustments.

- Depreciation of replacement property (MARCS) - Treas. Reg. §1.168(i)-6
  - Basis of Exchanged Property – generally "step in the shoes" of the relinquished property
  - Any excess basis – create as newly placed in service asset
  - Election to treat all basis as newly placed in service

How Does Debt Play in to All of This?

- Generally, relief of debt is considered income, and is taxable
- You must replace the value of the debt on the property, but it does not need to be new debt
- Example: a building with a $1,000,000 sales price, comprised of $600,000 in equity, and a mortgage of $400,000
  - Replacement property would need to valued at $1,000,000 or greater for complete gain deferral
    - If less, gain would be triggered

Other Exchange Requirements

- Two-party direct exchange
- Sale for cash and immediate reinvestment of cash does not qualify
- Transfers of relinquished and replacement properties through a qualified intermediary are treated as an exchange
- No requirement that the exchange be simultaneous; i.e. forward and reverse exchanges (explained later)

Other Exchange Requirements

- Special rules apply to multi-asset exchanges – Treas. Reg. 1.1031(j)-1
  - Generally, assets in the exchange are divided up in to groups
    - Section 1250 property: real property
    - Section 1245 property: tangible personal property
  - The gain that is deferred or recognized is computed by group, not as a whole
  - Especially important if the property, such as a building, has had a cost segregation analysis performed in the past

The Qualified Intermediary (“QI”)

- QI safe-harbor treatment requirements (Treas. Reg. §1.1031(k)-1(g)(4))
  - QI must not be a “disqualified person”
    - Employee, attorney, accountant, investment banker or broker, real estate agent or broker, or entity controlled by the taxpayer
    - Two-year lookback for a disqualified person
  - Exchange agreement must be written
  - Direct deeding allowed: assignment of purchase and sale agreements and notification requirements
  - Agreement must prevent taxpayer from receiving any “exchange funds” prior to end of 180-day replacement period (with certain exceptions)
  - May use qualified trust or qualified escrow

Examples

- **Forward exchange (with QI safe-harbor treatment)**
  - Taxpayer, Dunder Mufflin, enters into a contract with Xerox to sell their Scranton location, which contains a building and land (the relinquished property)
  - Dunder enters into a written exchange agreement with a QI, and the QI agrees to facilitate an exchange of the relinquished property in Scranton for replacement property, pursuant to the QI safe-harbor treatment in Reg. §1.1031(k)-1(g)(4)

Examples (cont.)

- **Forward exchange (continued)**
  - On or before the closing on the sale of the Scranton branch, Dunder assigns its rights in the sale contract to the QI and notifies the buyer, Xerox, of the assignment
  - At the closing on the sale of Scranton, Dunder deeds the relinquished property directly to Xerox and the proceeds of the sale (net of any debt on the relinquished property) are transferred by Xerox directly to the QI

Examples (cont.)

- **Forward exchange (continued)**
  - Within 45 days after the closing on the sale of Scranton, Dunder identifies at least three potential replacement properties in a written document that is delivered to the QI
  - Dunder ultimately enters into a contract to purchase replacement property, consisting of land and a building in Akron, OH
  - On or before the closing on the purchase of the Akron property, Dunder assigns its rights in the purchase contract to the QI and notifies the seller in writing of the assignment

Examples (cont.)

- **Forward exchange (continued)**
  - No later than 180 days after closing on the sale of Scranton (and before the expiration of the due date of the taxpayer's tax return), Dunder closes on the purchase of the Akron property
  - At the closing, the QI transfers the balance of the exchange funds (supplemented, as necessary by proceeds from new debt incurred or other cash provided by Dunder) to the seller and the seller direct deeds the Akron replacement property to Dunder

Examples (cont.)

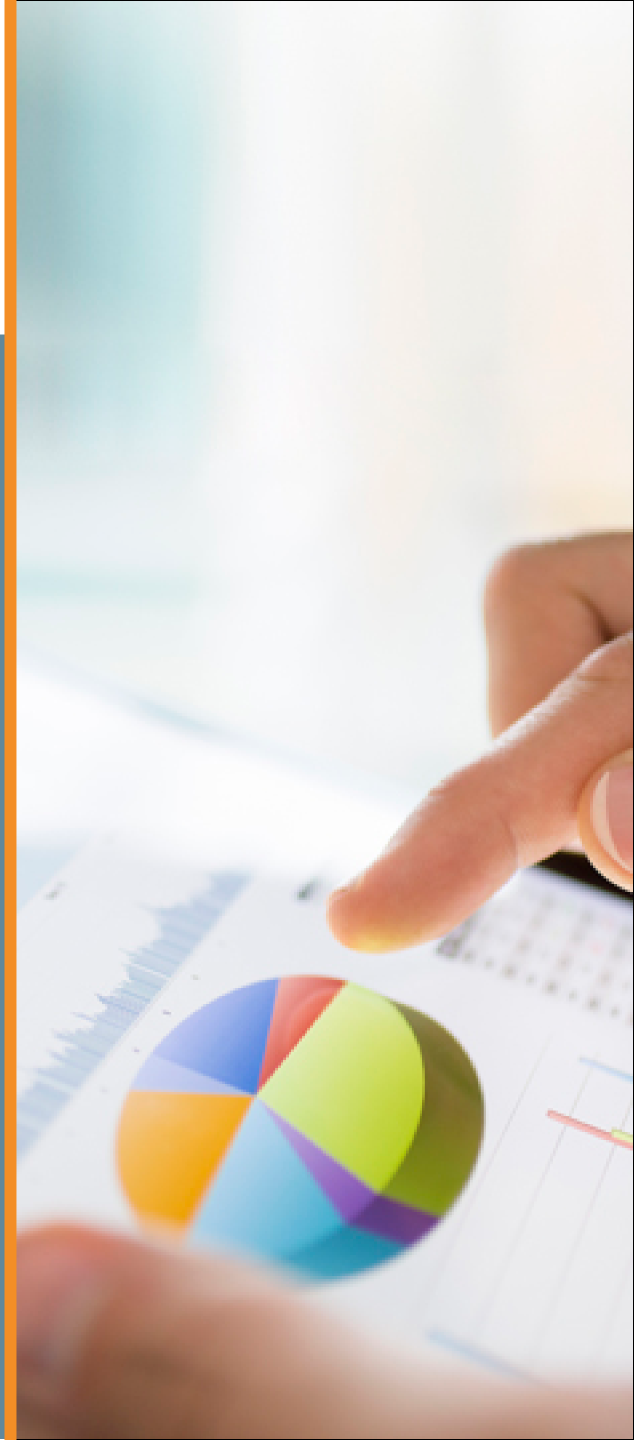
- **Simultaneous exchange**
  - Similar to a forward exchange, except both the relinquished and replacement properties are transferred at the same time

Examples (cont.)

- **Reverse exchange**
  - In this case, the QI has another role: exchange accommodation titleholder (EAT)
  - Replacement property, Akron in our example, is transferred to the EAT first
    - Qualified exchange accommodation agreement must be executed within five business days of the transfer
  - Within 45 days, identification the of relinquished property is identified (Scranton)
  - Within 180 days, Dunder must relinquish Scranton to the EAT, and take possession of Akron for the like-kind treatment to apply, similar to a forward exchange

Pros & Cons of a Like-Kind Exchange

- **Pros**
  - Deferral of taxes paid
  - Leveraged and increased cash flow for reinvestment
  - Relief from property management & maintenance burdens
  - Asset and net worth accumulation
    - Assets are stepped-up to their fair market value when transferred from an estate
- **Cons**
  - Administrative burden
    - Rules and procedures must be closely followed
  - Reduced basis on replacement property
  - Losses cannot be recognized (they are deferred until the replacement property is sold)



Thank you

Mat Whited

Tax Manager

513.338.8259

mbwhited@cshco.com

Chris Michel

Tax Senior

513.746.2791

camichel@cshco.com

Send feedback regarding today's webinar to kcshumate@cshco.com.