Like Kind Exchanges

Whenever you sell a business or investment property and you may have a gain, so generally you have to pay tax on the gain at the time of sale. IRC Section 1031 provides an exception and allows you to postpone paying tax on the gain if you reinvest the proceeds in similar property as part of a qualifying like-kind exchange. Gain deferred in a like-kind exchange is tax-deferred, but it is not tax-free.

IRS Section 1031 provides an opportunity to facilitate two transactions; the sale of the relinquished property and the purchase of the replacement property. The like kind exchange technique is among the most important of all tax provisions for real estate investors. I have closed a few bed and breakfast sales with this method. Basically, the first property is sold and the second property needs to be purchased within a certain amount of time and there will be no tax on the revenue that is put into the new property.

The exchange can include like-kind property exclusively or it can include like-kind property along with cash, liabilities and property that are not like-kind. If you receive cash, relief from debt, or property that is not like-kind, however, you may trigger some taxable gain in the year of the exchange. There can be both deferred and recognized gain in the same transaction when a taxpayer exchanges for like-kind property of lesser value.

Who qualifies for the Section 1031 exchange? Owners of investment and business property may qualify for a Section 1031 deferral. Individuals, C corporations, S corporations, partnerships (general or limited), limited liability companies, trusts and any other taxpaying entity may set up an exchange of business or investment properties for business or investment properties under Section 1031.

To accomplish a Section 1031 exchange, there must be an exchange of properties.

Deferred exchanges are more complex but allow flexibility. They allow you to dispose of property and subsequently acquire one or more other like-kind replacement properties.

To qualify as a Section 1031 exchange, a deferred exchange must be distinguished from the case of a taxpayer simply selling one property and using the proceeds to purchase another property (which is a taxable transaction). Rather, in a deferred exchange, the disposition of the relinquished property and acquisition of the replacement property must be mutually dependent parts of an integrated transaction constituting an exchange of property. Taxpayers engaging in deferred exchanges generally use exchange facilitators under exchange agreements pursuant to rules provided in the Income Tax Regulations. .

A reverse exchange is somewhat more complex than a deferred exchange. It involves the acquisition of replacement property through an exchange accommodation titleholder, with whom it is parked for no more than 180 days. During this parking period the taxpayer disposes of its relinquished property to close the exchange.

Both properties must be held for use in a trade or business or for investment. Property used primarily for personal use, like a primary residence or a second home or vacation home, does not qualify for like-kind exchange treatment.

While a like-kind exchange does not have to be a simultaneous swap of properties, you must meet two time limits or the entire gain will be taxable. These limits cannot be extended for any circumstance or hardship except in the case of presidentially declared disasters.

The first limit is that you have 45 days from the date you sell the relinquished property to identify potential replacement properties. The identification must be in writing, signed by you and delivered to a person involved in the exchange like the seller of the replacement property or the qualified intermediary. However, notice to your attorney, real estate agent, accountant or similar persons acting as your agent is not sufficient.

The second limit is that the replacement property must be received and the exchange completed no later than 180 days after the sale of the exchanged property or the due date (with extensions) of the income tax return for the tax year in which the relinquished property was sold, whichever is earlier. The replacement property received must be substantially the same as property identified within the 45-day limit described above..

If you do not specifically follow the rules for like-kind exchanges, you may be held liable for taxes, penalties, and interest on your transactions.

Consult a tax professional for additional assistance with IRC Section 1031 Like-Kind Exchanges.

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Most of you are aware than when a property is sold, the seller is taxed on the "capital gains" realized, which is the difference.