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"Like-kind" exchange can make capital gains tax disappear

by William J. Bryant, Esq.

Taxes can be an obstacle even in a sluggish real estate market. If you've held property for a long time, it may be worth substantially more than you paid for it, even if its value has declined in recent years. Also, years of depreciation deductions may have reduced or eliminated your tax basis in the property.

So if you're planning to sell property and capital gains will be triggered, find out if a like-kind exchange is an option for you. Also known as a Section 1031 exchange after the relevant section of the Internal Revenue Code, a like-kind exchange may be able to help you defer — or even permanently avoid — capital gains taxes.

The secret

The rationale behind Section 1031 is simple: You can defer the gain on real or personal property used in a trade or business or held for investment by exchanging it for replacement property of a like kind. For personal property, "like kind" means property in the same asset or product class — meaning you can't exchange a car for a backhoe.

For real estate, virtually any type of property will suffice, so long as it's business or investment property. You can exchange a factory for a farm or a shopping center for an apartment building; however, you can't exchange your personal residence unless you first convert it into rental property.

The magic

A successful Section 1031 exchange allows you to defer capital gains taxes until you sell the replacement property. If you hold the property for the rest of your life, you should be able to eliminate these taxes permanently: Your heirs will likely receive a stepped-up basis in the property equal to its fair market value when you die, thereby avoiding income tax on any previous appreciation in value.

The strategy

Despite the term "exchange," it's unusual to find someone with whom you can simply swap properties. Most Section 1031 transactions are deferred exchanges, in which the owner disposes of one property (the relinquished property) and then later acquires a replacement property. The strategy is to avoid gaining control of the proceeds from the sale of the relinquished property. If the IRS determines that you actually or constructively received the funds, your capital gains will become immediately taxable.

Fortunately, IRS regulations provide several safe harbors for Section 1031 exchanges. The most popular safe harbor involves the use of a qualified intermediary (QI) who receives and holds the proceeds from the sale of the relinquished property and uses them to purchase the replacement property. To qualify for tax-deferred treatment under a safe harbor, you must identify replacement property within 45 days after you sell the property you're relinquishing and complete the purchase within 180 days after the initial sale.

What if time is a concern?

Say you come across an ideal investment property that you'd like to trade into, but there's no time to sell an existing property. In that case, a similar safe harbor, called a reverse exchange, allows you to use a special type of QI, called an exchange accommodation titleholder (EAT).

In a reverse exchange, the EAT acquires the title to the replacement property *before* you sell the property you'd like to relinquish. There is a somewhat similar 45/180 day rule, but it's a more complex transaction that requires additional planning and has more traps than the "standard" exchange.

What are the risks?

A like-kind exchange offers many benefits, but there are potential traps that you should be aware of, including:

Getting the boot. Generally, it's best to exchange for property of equal or greater value. Any cash or other non-like-kind property — known as "boot" — that you receive is immediately taxable. Boot isn't always obvious: In addition to cash, it may include debt relief (for example, if a purchaser assumes your mortgage) and certain expenses or fees allocated to you at closing.

Being classified as a dealer. Real estate dealers — those in the business of buying and selling real estate — can't use a Section 1031 exchange to defer taxes on property held primarily for sale. Unfortunately, the line between a dealer and an investor isn't always clear. It depends on several factors, including the number of properties you own, frequency of sales, and extent to which you rely on subdividing, developing and advertising to increase sales.

Plan carefully

Under the right circumstances, like-kind exchanges can provide real tax savings, but they require careful planning. One wrong move can erase the tax benefits of an exchange, so be sure to do your homework and get professional advice.

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