

LIKE-KIND EXCHANGES

I. THE NUTS AND BOLTS OF LIKE-KIND EXCHANGES

A. LIKE KIND EXCHANGE

As set forth in section 1031 of the Internal Revenue Code, there is *no recognition of gain or loss upon the sale or 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.¹ In general, when property is

¹. Code Sec. 1031. Exchange of property held for productive use or investment

(a) NONRECOGNITION OF GAIN OR LOSS FROM EXCHANGES SOLELY IN KIND

(1) IN GENERAL

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.

(2) EXCEPTION

This subsection shall not apply to any exchange of--

- (A) stock in trade or other property held primarily for sale,
- (B) stocks, bonds, or notes,
- (C) other securities or evidences of indebtedness or interest,
- (D) interests in a partnership,
- (E) certificates of trust or beneficial interests, or
- (F) choses in action.

For purposes of this section, an interest in a partnership which has in effect a valid election under section 761(a) to be excluded from the application of all of subchapter K shall be treated as an interest in each of the assets of such partnership and not as an interest in a partnership.

(3) REQUIREMENT THAT PROPERTY BE IDENTIFIED AND THAT EXCHANGE BE COMPLETED NOT MORE THAN 180 DAYS AFTER TRANSFER OF EXCHANGED PROPERTY

For purposes of this subsection, any property received by the taxpayer shall be treated as property which is not like-kind property if--

(A) such property is not identified as property to be received in the exchange on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange, or

(B) such property is received after the earlier of--

(i) the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or

(ii) the due date (determined with regard to extension) for the transferor's return of the tax imposed by this chapter for the taxable year in which the transfer of the relinquished property occurs.

(b) GAIN FROM EXCHANGES NOT SOLELY IN KIND

If an exchange would be within the provisions of subsection (a), of section 1035(a), of section 1036(a), or of section 1037(a), if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(c) LOSS FROM EXCHANGES NOT SOLELY IN KIND

If an exchange would be within the provisions of subsection (a), of section 1035(a), of section 1036(a), or of section 1037(a), if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

(d) BASIS

If property was acquired on an exchange described in this section, section 1035(a), section 1036(a), or section 1037(a), then the basis shall be the same as that of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange. If the property so acquired consisted in part of the type of property permitted by this section,

section 1035(a), section 1036(a), or section 1037(a), to be received without the recognition of gain or loss, and in part of other property, the basis provided in this subsection shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. For purposes of this section, section 1035(a), and section 1036(a), where as part of the consideration to the taxpayer another party to the exchange assumed (as determined under section 357(d)) a liability of the taxpayer, such assumption shall be considered as money received by the taxpayer on the exchange.

(e) EXCHANGES OF LIVESTOCK OF DIFFERENT SEXES

For purposes of this section, livestock of different sexes are not property of a like kind.

(f) SPECIAL RULES FOR EXCHANGES BETWEEN RELATED PERSONS

(1) IN GENERAL

If--

(A) a taxpayer exchanges property with a related person,

(B) there is nonrecognition of gain or loss to the taxpayer under this section with respect to the exchange of such property (determined without regard to this subsection), and

(C) before the date 2 years after the date of the last transfer which was part of such exchange--

(i) the related person disposes of such property, or

(ii) the taxpayer disposes of the property received in the exchange from the related person which was of like kind to the property transferred by the taxpayer,

there shall be no nonrecognition of gain or loss under this section to the taxpayer with respect to such exchange; except that any gain or loss recognized by the taxpayer by reason of this subsection shall be taken into account as of the date on which the disposition referred to in subparagraph (C) occurs.

(2) CERTAIN DISPOSITIONS NOT TAKEN INTO ACCOUNT

For purposes of paragraph (1)(C), there shall not be taken into account any disposition--

(A) after the earlier of the death of the taxpayer or the death of the related person,

(B) in a compulsory or involuntary conversion (within the meaning of section 1033) if the exchange occurred before the threat or imminence of such conversion, or

(C) with respect to which it is established to the satisfaction of the Secretary that neither the exchange nor such disposition had as one of its principal purposes the avoidance of Federal income tax.

(3) RELATED PERSON

For purposes of this subsection, the term "related person" means any person bearing a relationship to the taxpayer described in section 267(b) or 707(b)(1).

(4) TREATMENT OF CERTAIN TRANSACTIONS

This section shall not apply to any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of this subsection.

(g) SPECIAL RULE WHERE SUBSTANTIAL DIMINUTION OF RISK

(1) IN GENERAL If paragraph (2) applies to any property for any period, the running of the period set forth in subsection (f)(1)(C) with respect to such property shall be suspended during such period.

(2) PROPERTY TO WHICH SUBSECTION APPLIES This paragraph shall apply to any property for any period during which the holder's risk of loss with respect to the property is substantially diminished by--

(A) the holding of a put with respect to such property,

(B) the holding by another person of a right to acquire such property, or

(C) a short sale or any other transaction.

(h) SPECIAL RULES FOR FOREIGN REAL AND PERSONAL PROPERTY

For purposes of this section--

(1) REAL PROPERTY Real property located in the United States and real property located outside the United States are not property of a like kind.

(2) PERSONAL PROPERTY

(A) IN GENERAL

Personal property used predominantly within the United States and personal property

exchanged solely for property of like kind, then there is no recognition of gain or loss. The properties exchanged must be held for productive use in a trade or business or for investment. Qualifying property for a 1031 exchange must either be held for productive use in a trade or business² or be held for investment.² To receive non-recognition as a like-kind exchange, both the property that is transferred (the relinquished property²) and the property that is received (the replacement property²) must meet the requisites for qualifying property. Property held for the productive use in a trade or business² may be exchanged for property held for investment² and still qualify as a like-kind exchange.²

used predominantly outside the United States are not property of a like kind.

(B) PREDOMINANT USE

Except as provided in subparagraphs (C) and (D), the predominant use of any property shall be determined based on--

- (i) in the case of the property relinquished in the exchange, the 2-year period ending on the date of such relinquishment, and
- (ii) in the case of the property acquired in the exchange, the 2-year period beginning on the date of such acquisition.

(C) PROPERTY HELD FOR LESS THAN 2 YEARS

Except in the case of an exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of this subsection--

- (i) only the periods the property was held by the person relinquishing the property (or any related person) shall be taken into account under subparagraph (B)(i), and
- (ii) only the periods the property was held by the person acquiring the property (or any related person) shall be taken into account under subparagraph (B)(ii).

(D) SPECIAL RULE FOR CERTAIN PROPERTY

Property described in any subparagraph of section 168(g)(4) shall be treated as used predominantly in the United States.

². Reg. Section 1.1031(a)-1(a)(1).

B. LIKE KIND

For property to qualify for exchange treatment, it must be:

- 1) held for productive use in a trade or business or
- 2) held for investment.

As used in section 1031(a) of the Internal Revenue Code, the words like kind have reference to the *nature or character of the property and not to its grade or quality*.³ The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class.⁴ Real property located within the United States and real property located outside the United States are declared to be properties not of a like kind, and exchanges of such properties therefore would not fall within the exception to the recognition of gain or loss.⁵ Real property held by tenants in common can qualify for exchange treatment.⁶

C. AHELD FOR@ REQUIREMENT

The real property must actually be held for use in a trade or business or be held for investment. For instance, property that is held primarily for sale or acquired with the intention to sell does not qualify for a 1031 exchange. If the owner of the property is under an existing obligation to transfer the property, then it will be considered that it was held primarily for sale.⁷

³. Reg. Section 1.1031(a)-1(b).

⁴. Reg. Section 1.1031(a)-1(b).

⁵. Code Section 1031(h)(1)

⁶. Rev. Rul. 73-476, 1973-2 C.B. 300, Rev. Rul. 79-44, 1979-1 C.B. 265.

⁷. *Griffin v. Comm=r*, 49 T.C. 253 (1967).

Real estate that is held by a nondealer of property for future use or future realization of the increment in value is considered held for investment.⁸

If property is merely acquired for the exchange, then it is not held for the investment purpose and will not be considered qualifying property.⁹ If the property is recently acquired from a decedent, the Internal Revenue Code nor the regulations specify whether the person receiving the property can qualify for a 1031 exchange. However, some rulings suggest that an heir may be able to exchange qualified real property acquired from a decedent as long as the property qualified while held by the decedent.¹⁰

The Internal Revenue Service will consider the use of the property that is relinquished and the use of the replacement property. Property that is received in a like-kind exchange (the replacement property) and then immediately sold, or used for a personal purpose, or transferred as a gift failed to qualify for non-recognition treatment.¹¹

In a 1989 ruling, the Tax Court held that the qualified use requirement was satisfied when a corporation exchanged real property and then liquidated the investment and distributed the replacement property to its shareholders.¹² However, in an earlier ruling, the IRS has denied 1031 treatment where a sole shareholder of a corporation acquired the property in a liquidation

⁸. Regs. '1.1031(a)-1(b).

⁹. Rev. Rul. 84-121, 1984-2 C.B. 168, Rev. Rul. 77-337, 1977-2, C.B. 305.

¹⁰. *Jayne Est. v. Comm'r*, 61 T.C. 744 (1974); PLR 9503015 and PLR 9604018 hold that the held for the investment requirement is met in exchanges of property received from decedents at a Section 2032A valuation.

¹¹. *Magneson v. Commissioner*, 81 T.C. 767 (1983).

¹². *Maloney v. Commissioner*, 93 T.C. 89 (1989).

of the corporation and subsequently exchanged the property.¹³ The IRS determined that the shareholder did not satisfy the Aheld for@ requirement because the productive use of the asset by the corporation could not be attributed to the shareholder.

The IRS has taken the position that the transfer of replacement property after the exchange to a limited liability company that is wholly owned by the taxpayer and that either elects to be disregarded as an entity or relies on the default classification rule for single-owner entities does not violate the requirement that the replacement property be held for productive use in a trade or business or for investment.¹⁴ The IRS has held that property received by partners in a partnership was held for investment and qualified for like-kind exchange treatment.¹⁵ In these situations, the investment was not actually sold for cash, even though there is a change in the form of ownership.

D. CANNOT CONSTRUCTIVELY RECEIVE MONEY

The seller must not actually or constructively receive the money for the relinquished property. This actual or constructive receipt of the money will disqualify the transaction for non-recognition treatment.¹⁶ If the taxpayer actually or constructively receives money or other property in the full amount of the consideration for the relinquished property before the taxpayer

^{13.} Rev. Rul. 75-292, 1975-2 C.B. 333 (a taxpayer who contributed the replacement property to his wholly-owned corporation immediately after the exchange did not hold the property for a qualified use); Rev. Rul. 77-337, 1977-2 C.B. 305 (a taxpayer who received property as a liquidating distribution from his wholly-owned corporation and then immediately exchanged it did not qualify for like-kind treatment).

^{14.} PLR 200131014.

^{15.} T.C. Memo 1988-273.

^{16.} Reg. Section 1.1031(k)-1(f).

actually receives like-kind replacement property, the transaction will constitute a sale and not a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property.¹⁷

The taxpayer is in constructive receipt of money or property at the time the money or property is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time or so that the taxpayer can draw upon it if notice of intention to draw is given.¹⁸ The taxpayer is not in constructive receipt of money or property if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. However, the taxpayer is in constructive receipt of the money or property at the time the limitations or restrictions lapse, expire, or are waived.¹⁹ In addition, actual or constructive receipt of money or property by an agent of the taxpayer is actual or constructive receipt by the taxpayer.²⁰

EXAMPLE. B and C agree to enter into a deferred exchange. Pursuant to the agreement, B transfers real property X to C. Real property X has a fair market value of \$100,000. Before the end of the identification period, B is to identify replacement property that is of a like kind to real property X. Before the end of the exchange period, C is required to purchase the property identified by B and to transfer that property to B. At any time after the date of the agreement and before C has purchased the replacement property, B has the right, upon notice, to demand that C

¹⁷

. Reg. Section 1.1031(k)-1(f).

¹⁸. Reg. Section 1.1031(k)-1(f).

¹⁹. Reg. Section 1.1031(k)-1(f).

²⁰. Reg. Section 1.1031(k)-1(f).

pay \$100,000 in lieu of acquiring and transferring the replacement property. Pursuant to the agreement, B identifies replacement property, and C purchases the replacement property and transfers it to B. Under the agreement, B has the unrestricted right to demand the payment of \$100,000 as of the date of the agreement. B is therefore in constructive receipt of \$100,000 on that date. Because B is in constructive receipt of money in the full amount of the consideration for the relinquished property before B actually receives the like-kind replacement property, the transaction constitutes a sale, and the transfer of real property X does not qualify for nonrecognition of gain or loss under section 1031. B is treated as if B received the \$100,000 in consideration for the sale of real property X and then purchased the like-kind replacement property. However, if B's right to demand payment of the \$100,000 were subject to a substantial limitation or restriction (e.g., the agreement provided that B had no right to demand payment before the end of the exchange period, then, B would not be in actual or constructive receipt of the money unless (or until) the limitation or restriction lapsed, expired, or was waived.²¹

The IRS has established safe harbors for meeting the requirements relating to constructive receipt in a 1031 exchange. These safe harbors apply as long as the party to the exchange does not have the unrestricted right to receive money. A person will not fail to qualify due to the fact that the obligation of the person, who is to transfer the replacement property to the taxpayer (the transferee), is secured or guaranteed by a mortgage, deed of trust, guarantee, or other security interest in the property.²² The obligation of the transferee may be secured by cash or a cash equivalent if the cash or cash equivalent is held in a qualified escrow account or in a

²¹. Reg. Section 1.1031(k)-1(f).

²². Reg. Section 1.1031(k)-1(g).

qualified trust as long as such escrow or trust meets the requirements set forth in the treasury regulations.²³ Additionally, the transfer may be made through a qualified intermediary subject to the provisions in the treasury regulations.²⁴

For example, if a person enters into an agreement for the transfer of relinquished property and thereafter assigns its rights in that agreement to an intermediary and all parties to that agreement are notified in writing of the assignment on or before the date of the transfer of the relinquished property, the intermediary is treated as entering into that agreement. If the relinquished property is transferred pursuant to that agreement, the intermediary is treated as having acquired and transferred the relinquished property.²⁵

E. IDENTIFICATION OF EXCHANGE PROPERTY - 45 DAYS

1) TIME FOR IDENTIFICATION OF REPLACEMENT PROPERTY

To meet the requirements for non-recognition treatment, the replacement property must be identified within forty-five (45) days after the date of the sale or exchange of the property relinquished in the exchange.²⁶ The identification period begins on the date the taxpayer transfers the relinquished property and ends at midnight on the 45th day thereafter.²⁷ If more than one property is relinquished as a part of the exchange, the period within which the property to be received must be identified begins as of the date of transfer of the first of such properties

²³. Reg. Section 1.1031(k)-1(g).

²⁴. Reg. Section 1.1031(k)-1(g).

²⁵. Reg. Section 1.1031(k)-1(g).

²⁶. I.R.C. 1031(a)(3)(A).

²⁷. Reg. Section 1.1031(k)-1.

relinquished.²⁸ If the replacement property is not identified within the forty-five day period, then the exchange will not qualify for non-recognition of gain.

2) MANNER OF IDENTIFYING REPLACEMENT PROPERTY

The replacement property must be identified in a written document signed by the person relinquishing the property and hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period to either of the following: (i) The person obligated to transfer the replacement property to the taxpayer or (ii) Any other person involved in the exchange other than the taxpayer or a disqualified person.²⁹ As set forth in the treasury regulations, persons that may be involved in the exchange include:

- a) any of the parties to the exchange,
- b) an intermediary,
- c) an escrow agent, and
- d) a title company.³⁰

3) DESCRIPTION OF REPLACEMENT PROPERTY.

Replacement property is identified only if it is unambiguously described in the written document or agreement. Real property generally is unambiguously described if it is described by a legal description, street address, or distinguishable name.³¹

4) ALTERNATIVE AND MULTIPLE PROPERTIES.

²⁸. Reg. Section 1.1031(k)-1(b)(2)(iii).

²⁹. Reg. Section 1.1031(k)-1(c)(2).

³⁰. Reg. Section 1.1031(k)-1(c)(2).

³¹. Reg. Section 1.1031(k)-1(c)(3).

The taxpayer may identify more than one replacement property.³² Regardless of the number of relinquished properties transferred by the taxpayer as part of the same deferred exchange, the maximum number of replacement properties that the taxpayer may identify is: (A) Three properties without regard to the fair market values of the properties (the "3-property rule"), or (B) Any number of properties as long as their aggregate fair market value as of the end of the identification period does not exceed 200 percent of the aggregate fair market value of all the relinquished properties as of the date the relinquished properties were transferred by the taxpayer (the "200-percent rule").³³

If, as of the end of the identification period, the taxpayer has identified more properties as replacement properties than permitted, the taxpayer is treated as if no replacement property had been identified.³⁴ Nevertheless, an identification will be considered made, if any replacement property is received by the taxpayer before the end of the identification period or for any replacement property identified before the end of the identification period and received before the end of the exchange period, but only if the taxpayer receives before the end of the exchange period identified replacement property the fair market value of which is at least 95 percent of the aggregate fair market value of all identified replacement properties (the "95-percent rule").³⁵

EXAMPLE: If, in a deferred exchange, B transfers property X with a fair market value of \$100,000 to C and B receives like-kind property Y with a fair market value of \$50,000

³². Reg. Section 1.1031(k)-1(c)(4).

³³. Reg. Section 1.1031(k)-1(c)(4).

³⁴. Reg. Section 1.1031(k)-1(c)(4).

³⁵. Reg. Section 1.1031(k)-1(c)(4).

before the end of the identification period, property Y is treated as identified by reason of being received before the end of the identification period. Thus, B may identify either two additional replacement properties of any fair market value or any number of additional replacement properties as long as the aggregate fair market value of the additional replacement properties does not exceed \$150,000.³⁶

Finally, an identification of replacement property may be revoked at any time before the end of the 45-day identification period.³⁷ To revoke an identified property, it must be made in a written document and signed by the party who is to receive the property and delivered either in hand, by mail, or other means before the end of the identification period to the person to whom the identification of the replacement property was presented.³⁸ If the identification was made in a written agreement for the exchange of properties, revocation may be effected only by a written amendment to the agreement signed by the party who is to receive the property and sent to all of the parties to the agreement.³⁹

F. **RECEIPT OF REPLACEMENT PROPERTY
EARLIER OF 180 DAYS OR DUE DATE OF TAX RETURN**

The second requirement of timing that must be met for an exchange of properties to be eligible for non-recognition treatment under Code Section 1031 is that the identified replacement property must actually be received before the end of the exchange period.⁴⁰ The exchange period

³⁶. Reg. Section 1.1031(k)-1(c)(4).

³⁷. Reg. Section 1.1031(k)-1(c)(6).

³⁸. Reg. Section 1.1031(k)-1(c)(6).

³⁹. Reg. Section 1.1031(k)-1(c)(6).

⁴⁰. I.R.C. 1031(a)(3)(B).

begins on the date that the relinquished property is transferred and ends on the date that is the earlier of 180 days after the date of the transfer or the due date (including any extensions) of the income tax return for the taxable year in which the relinquished property was transferred.⁴¹ As is the case with the determination of the period within which the replacement property must be identified, if more than one property is relinquished as a part of the exchange, the 180-day period within which the replacement property must actually be received begins as of the date of transfer of the first of such properties.⁴² If the replacement property may not be received timely, then it is possible to extend the time period by requesting an extension for the due date of the tax return.

At times, the receipt of replacement property may occur prior to sale or transfer of the relinquished property. These transactions are referred to as the reverse exchanges. A qualified intermediary may hold the replacement property. The same timing rules apply instead with references to the property to be relinquished versus the replacement property. For instance, the property to be relinquished must be identified within the forty-five (45) day period and must actually be transferred within the 180 day period.

G. RECEIPT OF PROPERTY THAT IS NOT LIKE-KIND

If other property or money is included as a part of the transaction which is not like kind, there must be recognition of some gain. If the exchange otherwise meets the requirements for non-recognition under Code Section 1031(a) except for the other property or money received, then gain must be recognized to the extent of the money and the fair market value of the other

⁴¹. Reg. Section 1.1031(k)-1(b)(2)(iii).

⁴²

. Reg. Section 1.1031(k)-1(b)(2)(iii).

property received.⁴³ However, the person is not allowed to recognize any loss on the exchange.⁴⁴ If liability on the property is assumed in the exchange, then the assumption of such liability is considered as money or other property and gain must be recognized to the extent of such money or other property.⁴⁵

EXAMPLE: A person relinquishes property with a cost basis of \$20,000 and exchanges it for the following: 1) replacement property with a fair market value of \$30,000 and 2) \$5,000 cash. The gain on the relinquished property is equal to \$15,000. However, if the exchange otherwise meets the 1031 requirements, then the person only has to recognize gain to the extent of the \$5,000 cash received while the remaining \$10,000 gain will be deferred.

H. PRINCIPAL RESIDENCE

Section 1031 does not apply to property that is used solely as a personal residence. However, an exchange of a certain property may meet the requirements for the exclusion of gain on the sale or exchange of a principal residence and the requirements for the non-recognition of gain under 1031. Under section 121(a) of the Code, a taxpayer may exclude gain realized on the sale or exchange of property if the property was owned and used as the taxpayer's principal residence for at least 2 years during the 5 year period ending on the date of the sale or exchange.

⁴⁶ Generally, the amount of the exclusion is limited to \$250,000 or \$500,000 for married couples

⁴³. I.R.C. 1031(b).

⁴⁴. I.R.C. 1031(b).

⁴⁵. I.R.C. 1031(d).

⁴⁶. I.R.C. 121(a); Rev.Proc. 2005-14.

filing jointly.⁴⁷ Any gain attributable to depreciation adjustments pursuant to section 1250 of the Code is not eligible for the exclusion.⁴⁸

Under certain circumstances, property that is used in a taxpayer's trade or business or held for investment can qualify for the exclusion of gain as a principal residence. The property may qualify for both the like kind provisions and the exclusion from the sale of a residence because the property does not have to be used as a principal residence at the time of its sale, but only as a principal residence for two years in a five year period of time. For example, the property could be used as a principal residence for two years and then used as rental property for next three years prior to being relinquished in a like kind exchange. Additionally, if a portion of the principal residence is used in a trade or business, the property could satisfy the requirements of both provisions. A taxpayer who uses a portion of a property for residential purposes and a portion of the property for business purposes is treated as using the entire property as the taxpayer's principal residence for purposes of satisfying the two year use requirement if both are within the same dwelling unit.⁴⁹

Taxpayers that exchange property that satisfies the requirements of both provisions may apply both the exclusion of gain from the exchange of a principal residence and the nonrecognition of gain from the exchange of like-kind properties under section 1031.⁵⁰ The exclusion of gain from the sale of a principal residence is applied to gain realized before

⁴⁷. I.R.C. 121(b); Rev.Proc. 2005-14.

⁴⁸. I.R.C. 121(d)(6); Rev.Proc. 2005-14.

⁴⁹. Reg. 1.121-1(e); Rev.Proc. 2005-14.

⁵⁰. Rev.Proc. 2005-14.

applying section 1031.⁵¹

EXAMPLE: Taxpayer A buys a house for \$210,000 that A uses as A's principal residence from 2000 to 2004. From 2004 until 2006, A rents the house to tenants and claims depreciation deductions of \$20,000. In 2006, A exchanges the house for \$10,000 of cash and a townhouse with a fair market value of \$460,000 that A intends to rent to tenants. A realizes gain of \$280,000 on the exchange. (ii) A's exchange of a principal residence that A rents for less than 3 years for a townhouse intended for rental and cash satisfies the requirements of both sections 121 and 1031. Section 121 does not require the property to be the taxpayer's principal residence on the sale or exchange date. Because A owns and uses the house as A's principal residence for at least 2 years during the 5-year period prior to the exchange, A may exclude gain under section 121. Because the house is investment property at the time of the exchange, A may defer gain under section 1031. (iii) A applies section 121 to exclude \$250,000 of the \$280,000 gain before applying the nonrecognition rules of section 1031. A may defer the remaining gain of \$30,000, including the \$20,000 gain attributable to depreciation, under section 1031. Although A receives \$10,000 of cash (boot) in the exchange, A is not required to recognize gain because the boot is taken into account for purposes of section 1031(b) only to the extent the boot exceeds the amount of excluded gain. These results are illustrated as follows. Amount realized \$470,000 Less: Adjusted basis \$190,000 Realized gain \$280,000 Less: Gain excluded under section 121 \$250,000 Gain to be deferred \$30,000 (iv) A's basis in the replacement property is \$430,000, which is equal to the basis of the relinquished property at the time of the exchange (\$190,000) increased by the gain excluded under section 121 (\$250,000), and reduced by the cash A receives

⁵¹. Rev.Proc. 2005-14.

(\$10,000).⁵²

II. STRATEGIES TO CONSIDER

A. 1031 EXCHANGE IS MANDATORY

A 1031 like-kind exchange is mandatory under the Internal Revenue Code. Therefore, if the transfer or exchange meets the requirements of a like-kind exchange under section 1031 of the Internal Revenue Code, then no gain or loss will be recognized on the sale or transfer of the property. There are certain circumstances where it may be advantageous to avoid the non-recognition treatment of a like-kind exchange. If this is the case, then the transaction will need to be structured to not qualify as a like-kind exchange.

B. PROPERTY THAT WILL INCUR A LOSS

The property to be sold or transferred may be subject to incurring a loss. Typically, it would be more advantageous to recognize the loss and offset it with current gains rather than to defer the loss with a like-kind exchange.

C. DEPRECIABLE PROPERTY

If the replacement property is to be depreciable property, then it may be beneficial to receive a higher cost basis in the property. The cost basis in the property is the amount that was paid for the property plus improvements to the property less depreciation taken on the property. For instance, if the property to be relinquished has a low basis, then the replacement property will receive the low basis, since replacement property acquires the attributes of the relinquished property. Therefore, it may be best to receive the higher basis for the cost of the new property to allow for this depreciation.

⁵². Rev.Proc. 2005-14.

D. NET OPERATING LOSS CARRYFORWARD

At times, the person may want to recognize the gain to offset other losses that it may incur in that tax period. Where otherwise, it may be necessary to carryforward these losses to another tax period. Additionally, the person may have a net operating loss carryforward from an earlier tax period which is about to expire. Once the loss carryforward expires, the person will not be able to offset such loss with any gains he or she may receive.

E. CAPITAL GAINS RATES

Another consideration is that the capital gains rates are currently only fifteen (15%) percent for long term gains on the sale of real property. These rates may increase in the future when the final sale of the property occurs and will result in an increased tax on the property.

F. STEP UP IN BASIS AT DEATH

A like-kind exchange may not only defer the gain on the property, but may result in no recognition of gain. Property that qualifies as a like-kind exchange may subsequently be transferred from a decedent. In this event, the beneficiary of the 1031 property from the decedent will receive a step-up in basis on the property at the time of death resulting in the deferral of the tax during the life of the decedent, then no recognition of the gain at the time of death.

III. PROPERTY CURRENTLY UNDER CONSTRUCTION

In general, a transfer of relinquished property in a deferred exchange will not fail to qualify for nonrecognition of gain or loss under section 1031 merely because the replacement property is not in existence or is being produced at the time the property is identified as

replacement property.⁵³ For example, if the identified replacement property consists of improved real property where the improvements are to be constructed, the description of the replacement property satisfies the requirements if a legal description is provided for the underlying land and as much detail is provided regarding construction of the improvements as is practicable at the time the identification is made.⁵⁴ For purposes of the requirements relating to the 200-percent rule and incidental property, the fair market value of replacement property that is to be produced is its estimated fair market value as of the date it is expected to be received by the taxpayer.⁵⁵

In determining whether the replacement property received by the taxpayer is substantially the same property as identified where the identified replacement property is property to be produced, variations due to usual or typical production changes are not taken into account.⁵⁶ However, if substantial changes are made in the property to be produced, the replacement property received will not be considered to be substantially the same property as identified.⁵⁷ If the identified replacement property is real property to be produced and the production of the property is not completed on or before the date the taxpayer receives the property, the property received will be considered to be substantially the same property as identified only if, had production been completed on or before the date the taxpayer receives the replacement property, the property received would have been considered to be substantially the same property as

⁵³. Reg. Section 1.1031(k)-1(e).

⁵⁴. Reg. Section 1.1031(k)-1(e).

⁵⁵. Reg. Section 1.1031(k)-1(e).

⁵⁶. Reg. Section 1.1031(k)-1(e).

⁵⁷. Reg. Section 1.1031(k)-1(e).

identified and only to the extent the property received constitutes real property under local law.⁵⁸

The transfer of relinquished property is not within the provisions of section 1031(a) if the relinquished property is transferred in exchange for services (including production services).⁵⁹ Thus, any additional production occurring with respect to the replacement property after the property is received by the taxpayer will not be treated as the receipt of property of a like kind.⁶⁰

EXAMPLE: If replacement property is identified as real property upon which improvements are to be constructed and at the time of the receipt of the property only 20 percent of the construction is completed, the property will be substantially the same as identified only if it would have been so considered had the construction been 100 percent completed. Under local law, real property constitutes real property to the extent of the underlying land and the 20 percent of the construction that is completed. Thus, the real property is considered to be substantially the same property as identified to the extent of the underlying land and the 20 percent of the construction that is completed when real property is received. However, any additional construction performed with respect to real property after the transfer, is not treated as the receipt of property of a like kind.⁶¹

If substantial changes are made after identification, the replacement property will not be considered substantially the same as identified and the exchange will be deemed a taxable sale.⁶²

⁵⁸. Reg. Section 1.1031(k)-1(e).

⁵⁹. Reg. Section 1.1031(k)-1(e).

⁶⁰. Reg. Section 1.1031(k)-1(e).

⁶¹. Reg. Section 1.1031(k)-1(e)(5).

⁶². Reg. Section 1.1031(k)-1(e)(3)(i).

Variations due to usual or typical production changes are not taken into account.⁶³ There is no extension of time for completion of the property.⁶⁴ The real property does not have to be completed.

If the real property is in the construction phase and not completed, the final product must be substantially the same as originally identified.⁶⁵

IV. REPORTING REQUIREMENTS

The like-kind exchange must be reported to the Internal Revenue Service on Form 8824.

If the person receives cash or other property that does not qualify for like kind, then the person must report the gain on Form 4797.

⁶³. Reg. Section 1.1031(k)-1(e)(3)(i).

⁶⁴. Reg. Section 1.1031(k)-1(e)(3)(iii).

⁶⁵. Reg. Section 1.1031(k)-1(e)(3)(iii).

ENDNOTES