Like-Kind Exchanges Under IRC Section 1031: A Primer

B. Wade Bowen
wbowen@mwlaw.com
(870) 938.6254

10/22/2021

Individual and business clients engaging in real estate transactions often have an interest in like-kind exchanges under Internal Revenue Code Section 1031 (hereinafter "1031" or "Section 1031"). Clients are usually aware that a properly structured 1031 exchange can reduce tax liability, but have questions about the more technical details of completing an exchange. Here, we aim to cover some of the basics related to exchanges:

What exactly is a 1031 exchange?

Section 1031 provides an exception to the general rule requiring current recognition of gain or loss upon the sale or exchange of property. It provides, in part:

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

Without the 1031 exception, gain would be recognized, and generally, capital gains tax would be owed on a gain upon the disposition of real property, even if it was swapped or exchanged for other real property.

The plain language of 1031 requires an "exchange," which is a reciprocal transfer of real property, as opposed to a transfer of property for money consideration. However, the receipt of *some* property not of a like kind will not completely disqualify an exchange. With limited exceptions, the same taxpayer must dispose of and acquire property in a 1031 exchange.

Why do we have the 1031 exception?

It is a long story. While the appreciation of an asset is undoubtedly economic income, mere appreciation is mostly excluded from the Code's computation of gross income. Rather, the Code generally taxes transactions, and imposes tax at a point in time when a taxpayer is in a position to pay it (in the case of the capital gains tax, after the sale of the capital asset). Congress passed the original version of Section 1031 on the premise that, after a like-kind exchange, the taxpayer is in a position very similar to taxpayer's position before the exchange, i.e., taxpayer has not cashed out of the investment, so taxpayer should not be taxed due solely to changing the form of the investment.

Does a 1031 exchange eliminate tax liability completely?

No. The 1031 exception is based upon the "continuity of investment" principle. When a taxpayer partially or completely "cashes out" of the investment, tax is owed on the taxpayer's gain.

To preserve the gain, the Code requires a basis carryover from taxpayer's relinquished property to its replacement property. To provide a rudimentary example, suppose a taxpayer owns a lot worth $100,000

in which taxpayer has a basis of $50,000. Taxpayer could sell the lot, and generally would owe capital gains tax on the $50,000 gain. But suppose the taxpayer found another lot worth $100,000, and its owner was willing to trade it for the lot owned by taxpayer. If the trade qualified as a 1031 exchange, taxpayer would not owe capital gains tax as a result of the trade, but taxpayer's basis in the new lot would be only $50,000 (as opposed to a full $100,000 had taxpayer sold the old lot, paid the tax, and then paid a full $100,000 to buy the new lot).

To the extent cash or property other than like-kind property is actually or constructively received by taxpayer in the course of an exchange, taxpayer pays tax as a result of receipt of that cash or non-qualifying property (called "boot"). In order to avoid boot, and therefore completely defer tax in a like-kind exchange, 1) the replacement property value must be equal to or greater than the relinquished property value and 2) all equity from the sale of the relinquished property must be invested into the replacement property. This typically means that any indebtedness on the relinquished property must be replaced by at least the same amount of indebtedness on the replacement property or that taxpayer must contribute cash out-of-pocked towards the purchase of the replacement property.

***What property qualifies under 1031*?**

Property qualifying under 1031 is real property of a like kind held for productive use in a trade or business or for investment. Real property held primarily for sale does not qualify under 1031, even if it is used in a trade or business. The phrases "held for productive use in a trade or business" and "held for investment" are not defined in the Code. However, other authorities clarify that qualifying property must be used in a trade or business in which the taxpayer is engaged, and that property that has been acquired for use in a trade or business may qualify even thought it has not actually been used. Treasury regulations clarify that unproductive real estate held by a non-dealer for future use or future realization of increases in value is held for investment.

How long does a taxpayer need to own property before it is "held"?

The phrase "held for" as used in Section 1031 is particularly important, as property that is not "held for" a qualifying use (i.e., in a trade or business or for investment) cannot qualify under Section 1031. The holding purpose, and not the holding period, is determinative of whether the "held for" test is met; the holding period is only one factor to consider. Nonetheless, many practitioners recommend a holding period of at least one year. This "held for" requirement applies to the property disposed of in the exchange (known as the "relinquished property") and the property acquired (known as the "replacement property").

***What kind of property is "like-kind"*?**

The type of real estate that can be exchanged under Section 1031 is broad. For instance, unimproved property can be exchanged for improved property. The fact that two pieces of real estate are of a different grade or quality does not prohibit them from being "like-kind."

Can property transfers occur at different times and still qualify as an exchange under 1031?

Yes. I use a simultaneous trade in the example above, but as a practical matter trades rarely occur. At one point in time, the IRS took the position that an exchange had to be simultaneous, i.e., taxpayer had to dispose of and acquire property at the same time for the exchange to qualify. This position was rejected by the *Starker* case from the Ninth Circuit in 1979.

To resolve some of the uncertainties from *Starker*, Congress added subsection (a)(3) to 1031 in 1984. It provides that any property received by the taxpayer will *not* be treated as like-kind property if (1) 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 property relinquished in the exchange, or (2) 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 extensions) for the transferor's return for the taxable year in which the transfer of the relinquished property occurs.

An exchange utilizing 1031(a)(3) is known as a deferred or delayed exchange.

How do deferred exchanges work?

1031(a)(3) clearly requires a taxpayer engaging in a deferred exchange to identify property to be received in the exchange within 45 days of disposing of property in the exchange and then actually receive the property within 180 days of the disposition (or sooner, to the extent the taxpayer's tax return is due within 180 days of the disposition and taxpayer does not file for an extension). The identification requirement is met by taxpayer unambiguously describing the replacement property in a written statement and delivering it to any person involved in the exchange other than the taxpayer or a "disqualified person." Meeting the receipt requirement is self-evident; taxpayer must take title in the replacement property by the deadline. As written, 1031(a)(3) contemplates a "forward exchange," in which taxpayer first sells relinquished property, then buys replacement property.

Treasury regulations provide four safe harbors for deferred exchanges. The most often used is the qualified intermediary safe harbor, in which a qualified intermediary ("QI") enters into an exchange agreement with the taxpayer and, under the terms of the exchange agreement, acquires the relinquished property from the taxpayer, transfers it to the purchaser, acquires the replacement property from the seller, and transfers it to the taxpayer.

Often, a taxpayer has entered into a contract to sell property and then opts to structure a deferred exchange. Taxpayer hires a QI to assist with the exchange, which might be a trust department within a bank or a special purpose entity owned by a title company. Counsel for taxpayer prepares the exchange agreement for execution by the taxpayer and QI. Thereafter, taxpayer assigns its rights in the real estate contract to QI, and QI participates in the real estate closing on taxpayer's behalf.

After closing, the net proceeds from the sale of the relinquished property are transferred to and held by QI. Within 45 days of closing, taxpayer identifies potential replacement property by delivering a written statement to QI describing the same. If taxpayer is able to get one or more of the identified replacement properties under contract, taxpayer assigns its rights under the contract to QI, QI participates in the closing by delivering the proceeds from the sale of the relinquished property to the title company to apply towards the purchase price of the replacement property, taxpayer funds any payment for the remainder of the purchase price, and taxpayer thereafter acquires the replacement property.

Through use of the QI, the taxpayer never actually or constructively receives any proceeds from the sale of the relinquished property. Thus, it is deemed an "exchange," i.e., a trade of property for property, as opposed to a sale and subsequent purchase, i.e., a disposition of property for cash, followed by an acquisition of new property for that same cash.

What happens if a taxpayer is under contract to purchase property instead of selling it?

A 1031 exchange can still be structured. Exchanges in which replacement property is purchased first are called reverse exchanges. They function similarly to forward exchanges, but have an extra step. After closing on the replacement property, it is transferred to a special purpose entity called an exchange accommodation titleholder and parked there until the relinquished property is ready to be sold. When the relinquished property is ready to be sold, the process described for the forward exchange is utilized to complete the exchange.

Can a taxpayer sell or buy more than one property in a 1031 exchange?

Yes, subject to certain regulatory limitations.

You mentioned boot above. How does that occur?

We will tweak the prior example to make it a deferred exchange. Assume that taxpayer sells its $100,000 lot, but has an interest in reinvesting and therefore structures a deferred exchange by hiring a QI before closing. The QI engages in closing, and holds the $100,000 in a QI account for taxpayer's benefit after closing. Taxpayer is unable to find a $100,000 property in which to reinvest, but does find an $80,000 property and QI closes on same. After applying $80,000 of the $100,000 to purchase the replacement property, QI returns the remaining $20,000 to taxpayer. Taxpayer pays capital gains tax on the $20,000, and its basis in the replacement property is adjusted upward to credit taxpayer for payment of the tax.