Tax Deferred Exchange

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*Written By Kelly S. Jason, Esquire Legal Update from the CC&IOR Newsletter*

# The Tax Deferred Exchange, An Opportunity for Investors

As a real estate investor, you may or may not be familiar with the tax deferred real property exchange vehicle commonly referred to as a "like-kind" exchange. Believe it or not, some real estate investors fail to take advantage of this opportunity or scurry to put together an exchange at the last minute, sometimes hours before the closing.

In principal, a tax deferred exchange is simple. In reality, however, there are specific requirements which must be met or the exchange will fail. Forethought, careful planning and professional advice will result in a financially rewarding and stress-free transaction.

The tax deferred exchange, as defined in Section 1031 of the Internal Revenue Code of 1986, as amended, allows for the deferral of the capital gain tax on the sale of an investment property. Section 1031 of the Code, provides, 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.

By deferring the capital gain liability, the investor (exchanger) has the ability to leverage all of the equity in the property sold (relinquished property) into a new property ( replacement property) of equal or greater value. Besides tax deferral, there are many other reasons for real estate investors to accomplish a property exchange, here are just a few examples.

- To acquire property with a higher cash flow. For example exchanging vacant property for a rental property;
- To change the nature of the property. For example, exchanging a residential rental property for a property the investor can occupy as his or her office space;

- To accommodate a lifestyle change. For example, a retiring investor could exchange an apartment building for a retail store thereby lessening the management burden.
- To change the location of investment property to an area where property is appreciating at a greater pace or may be easier to sell in the future.
- To consolidate several properties into one property.

Although there are many types of exchanges, the most common type of tax deferred exchange is the exchange of the same kind of property, a "like-kind exchange". There are many rules governing like-kind exchanges. The fundamental rules are: title to the relinquished property and the replacement property must be held in the same manner; the property must be qualifying property; the property must be like-kind property; the replacement property must be identified within 45 days after the date of the sale of the relinquished property; and, the replacement property must be received before the earlier of the 180th day after the sale of the relinquished property or the due date for the tax return for the tax year in which the transfer occurs; and the replacement property must be of greater or equal value.

Qualifying property is defined as property held for investment or used in trade or business. Like-kind property is defined as property of the same nature or character. Thus, real property cannot be exchanged for personal property. Note, however, real property situated in the United States and real property situated outside the United States are not like-kind properties. I This point emphasizes the need to be familiar with the rules and requirements governing like-kind exchanges and to seek professional guidance through the exchange process.

One of the most important requirements in a like-kind exchange is that the exchanger cannot actually or constructively receive any of the sale proceeds from the relinquished property. If the exchanger receives or constructively receives any of the sale proceeds, the transaction will be treated as a sale and the gain (or loss) will not be deferred. A common means to avoid this is to use an intermediary. Defined as a "qualified intermediary" in the IRS code, this is a person or entity that facilitates the exchange for the exchanger. The exchanger assigns his or her interest as seller of the relinquished property as well as his or her interest as buyer of the replacement property to the intermediary. The qualified intermediary becomes a principal in the transaction and will hold the sale proceeds until the purchase of the replacement property. The qualified intermediary cannot be the exchanger's agent at the time of the transaction, i.e. his or her attorney, accountant, real estate broker, etc.

There are many companies who offer qualified intermediary services, for a fee. Most will also prepare the necessary documentation. The use of professional qualified intermediary services can be invaluable in completing an exchange. Just be sure that the exchanger investigates the company before retaining their services.

The like-kind exchange is a great tool for ... customers looking to buy or sell investment property. Of course, anyone contemplating a tax deferred exchange must be advised to consult with his or her legal counsel and tax advisor. In the right circumstances, with the proper professional guidance, the exchange will go smoothly resulting in an very financially rewarding transaction.

This article is intended to provide the reader with a brief overview of like-kind real property exchanges and is not to be relied upon to determine whether or not such an exchange can be accomplished. Again, anyone contemplating a like-kind exchange must consult with their legal counsel and tax advisor.