Like-kind Exchanges

By JULIE A. DIALESSI-LAFLEY

Conducting a 'Like-kind' exchange under Internal Revenue Code section 1031 is one of the few legitimate tax shelters available to individuals, corporations and other business entities engaging in the disposition of assets.

This 1031 exchange, also known as a Starker or tax-deferred exchange, permits investment property owners to sell a property and defer tax payments by reinvesting the proceeds of the sale into 'like-kind' properties. Simply put, this tax-deferred exchange is an allowable method whereby a property owner trades one or more relinquished properties for one or more replacement properties of 'like kind,' while deferring the payment of federal income taxes and some state taxes on the transaction.

Unlike in a typical sale transaction, where the property owner is taxed on any gain realized from the sale, in a 1031 Exchange, the tax on the gain is deferred to the future. This supports the theory that when a property owner has reinvested sale proceeds into another property, the economic gain has not been realized in a way that generates funds to pay taxes. Therefore, it would be unfair to force the taxpayer to pay tax on a 'paper' gain.

Clearly, the ability to realize appreciation on property, reinvest the appreciation, and defer capital gains, depreciation, and taxes to a later date is advantageous to a property owner. If carefully followed, the procedure can be a financial boon, but there are other important benefits as well. The ability to maximize the use of equity, increase cash flow, and eliminate property management responsibilities are highly advantageous.

Through a 1031 exchange, an owner can use dormant equity in property to his/her best advantage by maximizing the inherent benefits of real estate investments. This equity can be used to upgrade the owner's investment real estate into larger, institutional-grade properties. The owner can purchase a Tenant-in-Common Interest in an institutional grade property, which would provide the property owners with an investment stream of income as well as reduce the property management responsibilities of owning a smaller-scale commercial property and being directly responsible for the management of that property.

A Tenant-in-Common Interest is simply an ownership interest in a property that has other individuals and entities holding an ownership share. As a tenant in common, a property owner owns a share in the whole of the property. Finally, a 1031 exchange structured as a Tenant-in-Common Interest ownership provides real estate investors a range of opportunities to meet personal investment objectives.

There are many REITs (Real Estate Investment Trusts) in existence that can provide this type of option of a property owner and a working relationship with a savvy financial planner and experienced attorney can accomplish this type of like-kind exchange.

By leveraging equity over several holding periods, a property owner can potentially produce higher actual dollar returns and accelerated equity accumulation as well as new depreciation schedules to tax shelter cash flow.

The broad like-kind provision for real property includes land, as well as rental, investment, and business property, any of which may be exchanged for another. Although personal property also can be subject to a like-kind provision, the rules governing it are far more restrictive. Personal (depreciable) property in productive business use can be exchanged solely for the same type of property.

In the exchange of real property, individual property owners should work closely with counsel to ensure that the transactions are structured to qualify under section 1031 to the greatest extent possible. Corporate and other business tax managers must rely on the expertise of their company's real estate managers to ensure strict compliance. Planning must be done with care; for example, the property being acquired is ready before the relinquished property is sold in some cases. With proper planning, one can still defer taxes.

In such transactions, the standard purchase-and-sale contact and/or real estate acquisition contract should contain specific provisions to allow the taxpayer to use a qualified intermediary to accomplish the section 1031 exchange. This important third-party shell-entity is retained as the property owner's agent so the property owner does not need to complete the exchange simultaneously with the sale of his/her appreciated property. The rules require that the exchange be completed within 180 days of the first leg of the transaction. The intermediary either holds the funds realized from a property's sale during the waiting period or takes the title to the replacement property pending the sale of the relinquished property, thus satisfying exchange requirements.

To completely defer the tax payments with a 1031 exchange, the replacement property must be of equal or greater value than that relinquished, and all equity from the sold investment property must be reinvested in the new property.

If a transaction is properly structured, the property owner is able to accomplish several objectives and maximize the benefits of appreciation. There is nothing to stop a savvy investor from continually deferring the capital gains taxes on his/her property by 1031 exchanging property for property for property. At death, the property owner can pass the appreciated property to his or her heirs and ultimately avoid taxes on any gains during his/her lifetime while still experiencing the benefits of the appreciated property. If done correctly it really is not too good to be true.

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