

I'll Trade You? Avoiding Taxes Through Like Kind Exchanges

By Julie Dialessi-Lafley, Esq.

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. And at this time of year, all of us want to avoid taxes of one kind or another.

Deferred Exchanges allow taxpayers to engage in transactions for the exchange of like kind property and avoid capital gains tax on the appreciation in the value of their property. A 1031 exchange (or a tax-deferred exchange) permits investment property owners to sell a property and defer tax payments by reinvesting the proceeds of the sale into a “like-kind” property.

Simply put, it is a 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 a typical sale transaction where the property owner is taxed on any gain realized from the sale, the tax on the gain in a 1031 Exchange is deferred until some future date. The theory is that when a property owner has reinvested the sale proceeds into another property, the economic gain has not been realized in a way that generates funds to pay any tax. In other words, the taxpayer’s investment remains the same, only the form has changed, i.e., a parking lot for an apartment building; 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 gain and depreciation in order to recapture taxes to a later date is advantageous to a property owner. The procedure, if followed carefully, can be a financial boon to a property owner—but there are other important benefits of a like kind exchange to the property owner. The ability to maximize the use of equity, increase cash flow and eliminate property management responsibilities all translate to benefits realized by the property owner.

This can be of paramount importance to an individual when contemplating their estate planning goals. The use of a 1031 exchange provides an opportunity to the property owner to realize the equity in an appreciated piece of

property, convert it to another potentially better piece of property or an appropriate investment such as a “tenant in common interest” arranged in certain REITs (Real Estate Investment Trusts), and still be able to pass the asset to his or her heirs without paying capital gains at the time of transfer or death.

1031 exchanges can provide real estate investors a range of opportunities to meet personal planning and investment objectives. These objectives can be of any sort including ownership of a specific property, specific location and quality of property. By investing in a tenant in common interest and meeting the investment goals, the property owner eliminates the day-to-day property management obligations of an individually owned property.

The like kind provision for Real property is quite broad, and includes land, rental property, investment property and business property any of which, can be exchanged for the other. Although personal property also can be subject to the like kind provisions, the rules governing the exchange of such property are far more restrictive.

In all exchanges, but particularly in the exchange of real property, individual property owners should work closely with their attorneys, accountants and financial advisors to ensure that the real property transactions are structured to qualify under section 1031 to the greatest extent possible.

Also, for all transactions contemplating an exchange, the standard purchase and sale contract governing the deal should contain specific provisions to allow the taxpayer to use a qualified intermediary to accomplish the section 1031 exchange.

A qualified intermediary, a third-party that is retained as the property owner’s agent, is of the utmost importance, as the property owner should not hold proceeds of the sale and also does not need to complete the exchange simultaneously at the time of sale of its appreciated property. The intermediary can hold the money or property. The rules require that the exchange be completed within 180 days of

the first “leg” of the transaction; thus, as long as the exchange is completed in that time frame the rules will have been satisfied.

In order to completely defer the payment of tax with your 1031 exchange, the replacement property must be of equal or greater value than the relinquished property, and all the equity from the sold investment property must be reinvested in the new investment property or properties.

In a typical transaction, the Property Owner enters into a sale agreement with buyer to sell a piece of real estate. Next the owner enters into an agreement with a qualified intermediary and assigns its rights to the agreement to the qualified intermediary. Buyer pays the qualified intermediary and owner transfers the real estate to buyer. Owner identifies a similar, “like-kind” property within forty-five days of the sale and enters into a purchase agreement with its seller and then assigns its rights to the purchase agreement to qualified intermediary. Finally, Owner directs qualified intermediary to pay cash to seller and seller transfers the purchased business asset directly to the corporation.

If the transaction is structured properly, the Property owner has been able to accomplish several objectives and maximize the benefits of appreciation in the property it owned. There is nothing to stop a savvy investor from continually deferring the capital gains taxes on his/her property by exchanging property for property for property and so on using the 1031.

At death, the property owner can pass the appreciated property to his or her heirs and ultimately have avoided taxes on any gains during lifetime while still experiencing the benefits of the appreciated property. If done correctly, this really is not too good to be true! ●

About the Author



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Julie A. Dialessi-Lafley, Esquire, is a multi-faceted attorney with the law firm of Bacon & Wilson, P.C., who focuses her practice in business law, real estate, estate planning and administration, and family law. She is committed to community service, serves on several charitable and organizational boards, and has been honored as a SuperLawyers Rising Star in *Boston Magazine* for the past two years. Julie is a frequent lecturer on legal topics and has written numerous articles that may be found on her website, bacon-wilson.com.

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