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A like-kind exchange is an interesting and creative strategy for deferring tax obligations

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If you're getting ready to sell property and have become discouraged when your advisor tells you how much tax you'll have to pay, take heart. What if we told you it doesn't have to be as bad as it seems as long as you know the rules? You may not have to pay these taxes at all—or at least not until some point in the future.

The general rule is that a gain or loss is realized upon the sale or exchange of property. However, an exception to this rule is provided under IRC § 1031. Under this rule, no gain or loss will be recognized on the exchange of property if such property is exchanged solely for property of like kind (which is defined broadly). In order to qualify for the non-recognition treatment, certain criteria need to be satisfied: the property received and relinquished must be property held for a productive use in trade or business or for investment; there must be an exchange; and the properties exchanged must be of "like kind."

By "like kind" we refer to the nature or character of the property and not to its grade or quality.

There are a variety of ways to structure a "like-kind" exchange, but the following are two of the most common forms:

- Seller and buyer swap properties (two party exchanges).
- Seller sells to buyer and seller purchases from third party (three-party exchange).

Like-kind exchanges under §1031 defer the current obligation to recognize any gain realized. It allows for the realized gain to be deferred until the replacement property is disposed of in a subsequent taxable transaction. In essence, one property with appreciation in value is "traded" for another property of greater value, allowing the owner to defer paying taxes on the gain because no cash is being taken out in the transaction.

The kind of real estate that can be exchanged within §1031 is extremely broad. The fact that real estate is improved or unimproved is not material because that relates only to the grade or quality and not to its kind or class. One kind or class of property may not be exchanged for property of a different kind or class. Examples of like-kind property exchanges include: exchange of city real estate for a

ranch or farm; real property exchanged for a leasehold of a fee with 30 years or more to run; real property subject to a 99-year lease exchanged for other real property not so encumbered; and receipt of condominium units following conversion of units of a cooperative housing corporation.

In addition, the statutory time limits must be met. The first limit requires the taxpayer (seller) to identify a replacement property before the 46th day after the date on which the taxpayer's original property is transferred. For identification purposes, clearly describing the replacement property in a written document or agreement will serve to identify the replacement property. The second time limit generally requires the taxpayer to receive the replacement property no later than 180 days after the taxpayer's original property is transferred.

For lack of a better word, "boot" is defined as the fair market value of non-qualified property received in a 1031 exchange. "Boot" refers to cash or personal property received that is necessary to even out an exchange which is not considered "like kind" as to the other property acquired in the transaction. A taxpayer who receives "boot" in a 1031 exchange will usually recognize gain to the ex-

tent of the fair market value of the "boot" received. The receipt of boot will not disqualify a 1031 exchange. The most common form of "boot" is usually cash received during or after a 1031 exchange.

In order to facilitate a like-kind exchange, the services of professionals are helpful. A real estate attorney can assist with structuring the deal and drafting the necessary documents; a tax accountant, experienced in this type of transaction will help ensure it is done in such a way as to comply with tax rules so it can truly be a tax-deferred transaction; lastly, a qualified intermediary is usually involved providing a suitable third-party account to park any cash associated with the transaction while the like-kind property is identified and all paperwork and documentation is completed.

As you can see, a like-kind exchange is an interesting and creative strategy for deferring tax obligations. With many investors sitting on sizeable real estate gains, these transactions are becoming increasingly common and one may be right for you.

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