Learning to Like Like-Kind Exchanges

Tax planning strategies can grow the value of your real estate portfolio

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Endnotes follow the article, on Page 35.

Sound tax advice must have its genesis in one of thousands of pages of complex tax law in the Internal Revenue Code. The good news is that Section 1031 of the tax code provides a mechanism for real estate investors to exchange properties and defer capital gains taxes. Exchanges of property under section 1031 are often referred to as "tax-free exchanges," "tax deferred exchanges," "like-kind exchanges," "Starker exchanges," and "section 1031 exchanges." They come in a variety of forms, including reverse[1] and simultaneous exchanges, and are allowed on a range of types of property, including personal property such as boats, cars and airplanes.[2] However, real property like-kind delayed exchanges are the most popular form used today.[3]

When selling real property consider structuring the transaction as a taxable sale on a 1031 tax-deferred exchange.[4] Section 1031 becomes more powerful when used in conjunction with other sections of the tax code because it provides a method to defer and possibly "never pay tax" on the capital gains from the exchange of investment real estate. For example, the tax on capital gains may be avoided through the combined use of sections 1031 and 1014; consequently, as property is passed on, your heirs may never pay tax on capital gains that occurred during your lifetime.[5]

A discussion of other forms and variations of the basic tax deferred exchange is beyond the scope of this article. The Web sites and reference publications listed on Page 35 provide information on the less frequently used forms of exchanges. We will focus on the concept and power of a tax-deferred exchange.

Personal Experience with 1031 "Like Kind" Exchanges

I first realized the power of a 1031 exchange when I discovered that it provided me with more investment capital than a taxable sale. When I invested in real estate, I planned to buy a property, make repairs, raise the rents and sell it for a profit using a 1031 exchange to defer the capital gains tax and buy a larger property.

When I decided to sell, I selected a nationally-based title company and a qualified intermediary. The qualified intermediary provided closing documents, an insured deposit, knowledge and experience, charging a total of approximately $800. Scott Saunders, Vice President of marketing at Asset Preservation Inc., told us "most qualified intermediaries charge between $500 and $1,000 for a straight forward delayed exchange with some small component of interest earned on deposit."

I was able to defer capital gains taxes of approximately $12,600 on a gain of approximately $45,000. Having the entire $45,000 to reinvest, I acquired a replacement property at a cost of more than $350,000. My net worth and gross income increased substantially and most importantly, my gross income increased by more than five times. The end result was better than the taxable alternative – paying approximately $12,600 to the IRS. I also would not have had the down payment for such a large replacement property and my subsequent income growth would have been substantially lower. Consider the result shown in Tax Treatment table on Page 33: every dollar in deferred taxes buys more real estate.

Although the transaction sounds relatively simple, there were many concepts that I worked to understand prior to the exchange. The next section provides a few things that I found helpful in understanding my role and other aspects of my exchange.

The General Scope of "Like Kind" Exchanges

The tax deferred exchange is a proven method that made its first appearance in the tax code in the 1920s.[6] However, it was not until the late 1960s that taxpayers began using a delayed exchange rather than the simultaneous exchange, or a literal swapping of property between two parties.[7] The tax deferred exchange is not a "loophole," which implies that the taxpayer is swindling the government. Section 1031 is a valid provision of the tax code.

Why would Congress choose to forego revenue from a capital gains tax – a tax on your profit? In general, the policy is that although there is an economic gain in the form of an increase in value of the property, a taxpayer who exchanges investment property is not recognizing actual gain on the disposition of their property because their investment continued in the replacement property. Additionally, section

1031 allows increased investor leverage; the theory is that the "government is now your investment partner."[8]

Although it is unnecessary to recite the tax code, a few concepts are helpful in understanding exchanges. First, a *gain* or *loss* will result when property is sold or otherwise "disposed of."[9] Next, the tax code distinguishes between *realized* and *recognized* gains and losses. The general rule provides all realized gains are recognized unless the tax code provides an exception.[10] The 1031 exchange is an exception to this rule.[11] Otherwise, the general rule requires that recognized gain is taxed at current capital gains rates of 20 percent.[12] Consider an exchange because the IRS's 20 percent cut will inhibit your buying power.

TaxTreatment

	Exchange	Sale
Selling Price	$150,000	$150,000
basis or Cost	$105,000	$105,000
gain or Profit	$45,000	$45,000
Capital gains tax rate[1]	28 %	28%
Capital gains tax paid	$0	$12,600
Reinvestment Capital	**$45,000**	**$32,400**
Possible acquisition[2]	$225,000	$162,000

Notes

[1] Current capital gains rate is 20 percent.

[2] Assumes a 20 percent downpayment

In a 1031 exchange, the deferred gain or loss is not recognized until the replacement property is subsequently sold or "disposed of" in a taxable transaction.[13] Understanding these concepts provides enough foundation to examine the specific requirements of the exchange.

Section 1031 exchanges are referred to as "like-kind" exchanges because the properties exchanged must be similar in "nature and character"[14] and be held for investment purposes.[15] The like-kind requirement is often interpreted broadly, especially in the case of real property.[16] Rental buildings, warehouses, manufacturing plants, office buildings and even improved or unimproved land qualify as like-kind property.

Section 1031 is complex, and timing is crucial for a successful exchange. For example:

- The "identification period" is the time allotted to identify your new property. It begins on the day you sell your property and ends at midnight 45 days later.[17]
- The "exchange period" is the time available for "receiving" your new property. It also begins on the day you sell your property, but generally ends at midnight 180 days later.[18]

The timing requirements are not flexible; these rules must be followed to the minute. For example, 180 days means 180 days, not six months – do not fall into this trap. Qualified intermediary Web sites often provide timing calculators[19] and even more useful 1031 exchange calendars.[20]

Additional factors may affect the tax deferred nature of your exchange. One example is the receipt of boot. The tax code defines *boot* as property that is not "like-kind," such as cash or stocks.[21] Not nearly as popular as the cowboy variety, boot is taxable because it triggers *recognition of gain*.[22] An investor who takes "actual" or "constructive" receipt of boot must pay taxes.

The First American Exchange Corp. Web site explains that, "the regulations prohibit actual or constructive receipt of cash or other property. This means the taxpayer may not receive cash in hand, nor may he derive economic benefit from cash or other property in the exchange escrow account. For example, the taxpayer may not pledge cash in the escrow account as security for a loan to the taxpayer during the exchange."

Many investors may not consider an exchange because they believe that their equity must remain in the replacement property. Equity must not always remain invested in real estate because of a 1031 exchange. Exchangers who want cash should consider the possibility of refinancing. Consult with your attorney to develop a strategy to acquire and refinance replacement property. In most circumstances, cash received as a result of refinancing replacement property is ususally not taxable and may be used for any purpose, including: acquiring additional real estate, paying bills, paying off other high-interest loans or vacationing at your favorite resort. Special care should be exercised in refinancing property prior to or directly following an exchange.[23]

Now that you have a basic idea of what the tax code says about tax-deferred exchanges, you are undoubtedly thinking, "this is so great, where and how do I start?" Here is how it works, from a practical standpoint.

A property owner advertises or lists a property for sale. Sooner or later, maybe after an asking price reduction, a buyer makes a contractual offer to purchase the property. The seller has an attorney draft a counter offer that contains binding language to the effect that the "buyer will cooperate in facilitating the seller's 1031 exchange."[24] When the parties arrive at acceptable terms and the offer is accepted, the earnest money contract is delivered to a title company. Copies are forwarded to a qualified intermediary.

At the closing the exchanger assigns his rights under the earnest money contract to the qualified intermediary and the property is deeded to the buyer. The title company then transfers the net equity to the qualified intermediary and the deposit starts to earn interest. In the next phase of the exchange, the exchanger identifies replacement property and closes on it within the appropriate time limits; the qualified intermediary applies the net equity to the purchase price; and the replacement property is deeded to the exchanger.

Buyers and sellers often negotiate to determine the length of escrow or time between signing the contract and closing on the sale of the relinquished property. Put time on your side and hedge against the 45-day time period by: 1) identifying your replacement property; 2) researching and contacting qualified intermediaries; and 3) ensuring that the replacement property is like kind. Some qualified intermediaries maintain that "even if no language was included in the earnest money contract, many real estate investors contact a qualified intermediary just minutes before closing on their transaction and successfully convert a sale into an exchange. In most situations, a successful exchange can be accomplished as long as the qualified intermediary is contacted and all necessary exchange documents are executed prior to closing."[25]

However, rushing into an exchange presents tax and financial risks. For example, earnest money could be taxable boot. The financial risk is that the exchange could be classified as a taxable. It becomes the ultimate financial risk where the taxpayer has insufficient cash to pay the gains tax. Risks may be avoided by proper planning and research.

Helpful Qualified Intermediary Web Sites

The qualified intermediary takes center stage in the 1031 exchange and is involved from start to finish. As a potential exchanger, you have several methods available for researching and selecting a qualified intermediary. They include: (1) the qualified intermediary associated with your title company; (2) your attorney or accountant's recommendation; or (3) research via the Internet and other sources.

The Internet provides a wealth of information. Depending on search criteria, search engines find approximately 1,000 Web sites with 1031 exchange helpful content. The best sites represent less than one percent of the total and are affiliated with large title companies. The balance are assembled by real estate agents, brokers and other practitioners who use the hype of a 1031 exchange to generate listings and property sales.

At right is a list of helpful Web sites for 1031 exchanges. The exchange service companies supporting these sites seem to have several things in common: 1) they are either an affiliate, subsidiary or closely related to a title company; 2) they advertise required bond insurance coverage; 3) they generally have more than 10 years experience operating as a corporation; 4) and they are members of the Federation of Exchange Accommodators. A few distinguishing features of each site are described below.

Investment Property Exchange Services, Inc., found at *www.fnx1031.com*, is a subsidiary of Fidelity National Financial, Inc., the world's largest title insurance organization. The Fidelity National umbrella covers Fidelity National Title, Chicago Title, Ticor Title, Security Union Title and Alamo Title. The Investment Property Exchange Services Web site features a variety of briefs on more complex issues associated with exchanges as well as a comprehensive checklist that may be useful in planning an exchange.

Old Republic Exchange Facilitator Company also has unique features. First, unlike any of the other Web sites, Old Republic publishes its fee schedule for basic types of exchanges. In addition to providing answers to common questions, the Web site includes graphics that are useful in explaining complex tax language. Finally, the site features an 18-page booklet that you can download and print.

Helpful Web Sites

Fidelity National 1031 Exchange Services Inc.
- www.fnx1031.com

Old Republic Exchange Facilitator Company
- www.oldrepublictitle.com

Asset Preservation, Inc.
- www.apiexchange.com

First American Exchange Corp.
- www.firstamex.com

Asset Preservation, Inc., offers a "Letter of Assurance," by which Stewart Title Company provides a Third Party Guarantee that "assures" the performance of API. In the company's 11-year history, API has successfully facilitated over 60,000 real and personal property exchanges. Their site – *www.apiexchange.com* – provides a mechanism that allows you to e-mail any of 40 articles from the site to yourself, a prospective buyer or your CPA or attorney.

First American – *www.firstamex.com* – also provides valuable online resources. Their Web site offers a comprehensive short course on 1031 exchange practice, and they post an excellent 15-step explanation of how a 1031 exchange works. They also give a thorough explanation of the costs associated with the 1031 exchange.

While we do not distinguish the top Web site, we did talk with Scott Saunders, vice president of marketing at Asset Preservation. Saunders says the most important things to consider are the security, service and experience of your qualified intermediary. For example, some services commingle funds with other sellers funds. Others specifically isolate your deposit funds and at your request will require a notarized signature before transferring your funds. Your attorney understands the security of your funds and your remedy if something goes wrong.

Conclusion

The suggestions in this article were made to explain the concept of a 1031 exchange, demonstrate some of the pitfalls and provide additional sources of information. These suggestions show how tax planning can help to avoid or defer – but not evade – taxes, and that avoiding taxes can save time and money. Most important: the section 1031 exchange is not a loophole – it is a provision of the tax code that allows an individual to sell property wisely and legally defer the capital gains tax.

With appropriate tax planning, a 1031 exchange generally allows a real estate investor to defer and possibly eliminate the capital gains tax in the sale of a property. Like most tax laws, section 1031 is complex. If you are considering a 1031 exchange, be sure to do appropriate tax planning. Consult a CPA, a qualified intermediary and your attorney to determine if a 1031 exchange is appropriate and compatible with your investment goals. Most qualified intermediary's advertise free consultations by way of a toll free number on their Web sites. Seek advice of a tax attorney who is knowledgeable about real estate to ensure that your contracts are structured tightly and meet the 1031 requirements.

Notes

[1] See *www.oldrepublictitle.com/exchangefacilitator/1031 exchange/1031tde8.htm* last visited March 4, 2002 (defining "[d]elayed exchange – Also called non-simultaneous, deferred, and Starker"]). See also I.R.C. section 1031 and *www.oldrepublictitle.com/exchangefacilitator/1031exchange/1031tde7.htm* last visited on March 4, 2002 (stating that a simultaneous exchange is "[a]lso referred to as a concurrent exchange, [and defining] a simultaneous exchange [a]s an exchange transaction in which the Exchanger transfers out of the Relinquished Property and receives Replacement Property at the same time").

[2] See 26 C.F.R. section 1.1031(a)(2).

[3] See *www.apiexchange.com/indexa.html* (stating that "[a] delayed exchange is the most common exchange format, providing investors the flexibility of up to a maximum of 180 days to purchase a replacement property.")

[4] See 26 C.F.R. section 1031.

[5] See I.R.C. section 1014 (providing that an heir takes a stepped up basis in property acquired from a decedent). Online, visit *www.firstexchange.com/firstexchange/train.html* (further explaining that "[u]nder Internal Revenue Code section 1014, upon death all property in the decedent's estate is entitled to a stepped-up basis for purpose of calculating the heirs' capital gain upon a subsequent sale. Under this rule, property is valued as of the date of the decedent's death for purposes of determining its "basis," without regard to when the property was originally acquired or its original basis. This allows an heir to avoid tax liability for all capital gains during a decedent's lifetime. While in some cases the benefits of this rule may be lessened by federal estate taxes or state inheritance taxes, potential for "stepped-up basis" is an important factor to be considered in anyone's estate planning.") See id.

[6] See *www.firstexchange.com/firstexchange/train.html* last visited on March 4, 2002 (recounting the history of Internal Revenue Code section 1031 and tracing its origins to the 1920's").

[7] See *www.firstexchange.com/firstexchang/train.html* (stating that "[f]or many years taxpayers and their advisors had no comfort doing anything other than a simultaneous exchange. In fact, the IRS narrowly interpreted section 1031 and threatened to audit and penalize taxpayers whose dealings didn't fit its narrow interpretation. What changed all of this, forever, was the Starker case, a landmark court decision"). See also *Starker vs. United States*, 602 F. 2d 1341 (9th Cir. 1979).

[8] See *www.firstexchange.com/firstexchange/ train.html* last visited on March 4, 2002 (explaining that "[b]y deferring payment of taxes, the taxpayer has use of "the government's money" to pursue personal income or investment goals").

[9] See I.R.C. section 1001(a).

[10] See I.R.C. section 1001(c).

[11] See I.R.C. section 1031.

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[12] See I.R.C. section 1(h)(1)(C).

[13] See I.R.C. section 1001.

[14] See 26 C.F.R. section 1.1031(a)-1(b).

[15] See I.R.C. section 1031(a)(1).

[16] See *www.apiexchange.com/indexa.html* last visited on March 4, 2002, (stating that "[c]ontrary to the commonly held misconception that exchanged properties must be of the exact same type - for example, that bare land be exchanged for bare land or an income property be exchanged for another income property - the actual definition of "like-kind" is far more empowering in its flexibility. Any real property held for investment or real property used in a trade or business can be exchanged for any other real property held for investment or real property used in a trade or business.").

[17] See 26 C.F.R. section 1.1031(k)-1(b)(2)(i).

[18] See I.R.C section 1.1031(k)-1(b)(2)(ii).

[19] See *www.apiexchange.com/indexa.html* last visited March 4, 2002, (providing 45/180 day calendar).

[20] See *www.firstamex.com.*

[21] See I.R.C. section 1031(b).

[22] See I.R.C. section 1031(b).

[23] Courts have developed several judicial doctrines in case law that the IRS sometimes uses against taxpayers. The step transaction doctrine could come into play here. If applied in a refinancing case, It could have the effect that the investors intent was to take cash out of the property by and avoid the requirements of section1031 that require continuity of investment. See *www.fnx1031.com/example/brxch14.html* stating that:

> The question then posed is, what about refinancing the property to obtain the funds? Refinancing a property to obtain cash is a non-taxable event. However, a refinance, if part of an integrated transaction that includes an exchange or anticipation of an exchange, may be taxed as the receipt of boot. In Fredericks v. Commissioner, T.C. Memo 1994-27 CCH Dec 49,629(M) the IRS attempted to tax a refinance which took place less than a month before the exchange. The Exchanger prevailed on the facts when they proved the refinance, begun two and one-half years earlier, was coincidental with the exchange.
>
> There is no authority to differentiate between a refinance prior to an exchange and a refinance after an exchange. However, various commentators express the opinion that a post exchange refinance should have no tax consequences whether integrated with, or immediately following, the exchange. The rationale is two-fold: 1) The Exchanger remains liable for a refinance after the exchange but is relieved from liability for a refinance prior to the exchange; 2) A refinance after the exchange does not increase the Exchangers net worth.

[24] Several Web sites contain suggested language for this provision. See *www.apiexchange.com/indexa.html* (proposing for the sale of relinquished property that "[b]uyer is aware that Seller intends to perform an IRC section 1031 tax deferred exchange. Seller requests Buyer's cooperation in such an exchange and agrees to hold Buyer harmless from any and all claims, liabilities, costs, or delays in time resulting from such an exchange. Buyer agrees to an assignment of this contract to Asset Preservation, Inc. by the Seller." Also proposing that for purchase of replacement property "[s]eller is aware that [b]uyer intends to perform an IRC section1031 tax deferred exchange. Buyer requests Seller's cooperation in such an exchange, and agrees to hold Seller harmless from any and all claims, liabilities, costs, or delays in time resulting from such an exchange. Seller agrees to an assignment of this contract to Asset Preservation, Inc. by the Buyer.") See also *www.fnx1031.com/basics/xchb6.html* last visited on February 25, 2002 (proposing "[b]uyer hereby acknowledges it is the intent of the Seller to effect an IRC section 1031 tax deferred exchange which will not delay the closing or cause additional expense to the Buyer. The Seller's rights and obligations under this agreement may be assigned to Fidelity National 1031 Exchange Services, Inc., a Qualified Intermediary, for the purpose of completing such an exchange. Buyer agrees to cooperate with the Seller and Fidelity National 1031 Exchange Services, Inc. in a manner necessary to complete the exchange." This also provides an example of even how the best Web sites are not all inclusive as the fnx1031.com site does not provide language for both sides of the transaction.)

[25] See *www.apiexchange.com/indexa.html.*