What you need to know

Like-Kind Exchanges

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What you need to know:

Like-Kind Exchanges

Investors often wish to change the form and/or nature of their investments but do not want the capital gains tax liability resulting from traditional sales. A popular way to accomplish reallocation of investments, while deferring the tax on the gains, is to execute a like-kind exchange (IRS section 1031, also referred to as a Starker exchange).

FAST FACTS

- A like-kind exchange is swapping one business or investment asset for another, without recognizing any built-in gain for tax purposes
- When the transaction involves cash or non-like-kind property, the cash/property is called boot
- Leased property may qualify for like-kind treatment

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Reallocating Investments without Capital Gain Consequences

A like -kind exchange is swapping one business or investment asset for another, without recognizing any gain for tax purposes. The realized gain (or loss) does not disappear; rather it carries over to the new asset. The 1031 rules do not apply to stocks, bonds, notes, other securities, debt holdings or interests in a partnership. That said, there are multiple types of properties that DO qualify in a like-kind exchange. Real estate is by far the most common.

To qualify, properties must meet a few basic requirements.

- Must be held for investment or used in a trade or business (not personal residence).
- Properties must be of "like-kind." The nature, character and the taxpayer's intent for the replacement property are all determining factors for qualification.
- IRS timing rules must be met if replacement property ownership is not immediate (delayed).
- Investor cannot be in "constructive receipt" of the old property proceeds.

FYI

With things always changing, be sure to talk with Reilly, Penner & Benton to see what the most current rules, regulations and changes may apply to you when working with like-kind exchanges.

While a like-kind exchange can provide an excellent tax deferral strategy, investors need to be aware of potential mistakes and restrictions that can cause problems. If not structured properly, an exchange could leave an investor with a recognized tax gain without any net cash proceeds to pay the tax liability.

Boot

When the transaction involves cash or non-like-kind property, the cash/other property is called boot. Boot received in the transaction causes recognition of a gain, but only to the extent of boot received. Boot calculation becomes especially complex when property debt is involved. The Tax code treats relief from indebtedness as additional cash boot in a like-kind exchange.

Multiple Properties

Multiple properties: The exchange may include multiple properties, but multiple properties are subject to additional IRS restrictions to qualify as like-kind.

Delayed exchange

Delayed exchanges are sometimes referred to as "Starker exchanges." This reference is from the 1979 court case Starker v. United States. It revolved around the issue of timing in a like-kind exchange. The regulations and legal proceedings resulting from this decision shaped significant laws and tax rules for like-kind exchanges that are still in place today.

Investors are not required to have their specific replacement property lined up at the time of sale. However, they must not be in "constructive receipt" of the sale proceeds. This is accomplished by using a qualified intermediary to process the sale and the subsequent purchase of the replacement property.

The IRS places limits on the maximum length of time to identify and close on the replacement property and it does not generally allow extensions.

Vacation Property (second home)

Can a vacation home be included on either end of a qualified exchange? The answer is yes and no. Technically the 1031 rules prohibit personal residences from being included. However, converting a personal residence to a rental property for a period of time can qualify it. There are ownership, rental use, owner intent and personal residence tests to meet in order for these types of homes to qualify.

While the 1031 exchange rules allow flexibility and can be an excellent tax deferral strategy they are not without complexity. Each exchange is different and comes with its own challenges. Reilly, Penner & Benton, LLC is here to help you navigate the compliance difficulties for 1031 exchanges and other tax strategies.

Contact our Tax team at

414.271.7800 with any questions