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General Rules Regarding Like-Kind Exchanges

CONSTRUCTION, REAL ESTATE, TAX
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Whenever you sell business or investment property and you have a gain, you generally have to pay tax on the gain at the time of sale. Internal Revenue Code (IRC) Section 1031 provides an exception and allows you to defer paying tax on the gain if you reinvest the proceeds in similar property as part of a qualifying like-kind exchange.

The rules under IRC Section 1031 can be very complex; however, there are a few basic rules that can assist you in determining if you can benefit from a like-kind exchange.

RULES OF THE 1031 LIKE-KIND EXCHANGE

- **Rule One**: Both the relinquished property you sell, and the replacement property you buy must be held for use in a trade or business or for investment. Generally, property used primarily for personal use, like a primary residence, does not qualify for like-kind exchange treatment.
- **Rule Two**: Both properties must be similar enough to qualify as "like-kind." Like-kind property is property of the same nature, character or class. Quality or grade does not matter. Most real estate will be like-kind to other real estate.
- **Rule Three**: You must satisfy two time limitations or the entire gain may be taxable. First, you have 45 days from the date you sell the relinquished property to identify potential replacement properties. The identification must be in writing, signed by you and delivered to a person involved in the exchange like the seller of the replacement property or the qualified intermediary. The second time limit is that the replacement property must be received and the exchange completed no later than 180 days after the sale of the exchanged property or the due date (with extensions) of the income tax return for the tax year in which the relinquished property was sold, whichever is earlier.
- **Rule Four**: To totally defer the taxable gain in an exchange, you must trade up in (or equal to) both value and equity from the relinquished property to the replacement property.
- **Rule Five**: When trading down in value or equity, you are taxed on the greater of the trade down in value or equity from the relinquished property to the replacement property, but only to the extent of the realized gain from the exchange.
- **Rule Six**: Your tax basis in the replacement property equals the fair market value of the replacement property less the amount of gain that you deferred from the like-kind exchange.

The rules listed above only begin to scratch the surface of the rules under IRC Section 1031. However, having knowledge of these rules will assist you in determining if you can benefit from this tax planning opportunity. In addition, it is important to note that not all states recognize the federal like-kind exchange rules, so it is important to research and understand the state tax implications when you enter into a like-kind exchange transaction.

Contact us to discuss the rules of like-kind 1031 exchanges, or with any other questions and visit our Construction and Real Estate Industry Group pages for more information.

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