

# Like-kind property exchanges can avoid gains taxes

Section 1031 of the U.S. Tax Code allows an owner to exchange real or personal property held for investment or productive use for comparable like-kind property and defer the capital gains tax that would otherwise be due until after the replacement property is sold.

That means a significant tax savings with appreciated property.

Ordinarily, when someone sells property the taxable income is calculated by subtracting the basis (original purchase price or investment in the property) from the sale price. For example, if someone bought an acre for \$1,000 in 1990 and sold it for \$10,000 in 2010, the taxable income would be \$9,000.

The sale price includes money paid and the value of any property received. Using the same example, if the seller received \$10,000 plus new land worth \$5,000 in return for his old land, the taxable income is \$14,000 (\$10,000 cash plus \$5,000 land minus \$1,000 basis) because the value of the new land was added consideration for the sale of his old land.

## Simultaneous exchange

A direct exchange of property between two parties is the simplest Section 1031 exchange. Assume two people want to trade land. The seller has land worth \$10,000 with a basis of \$1,000, and the buyer also has land worth \$10,000. An exchange means the seller has no taxable income. His \$1,000 basis is the land acquired is the same as for the land transferred.

The gain is deferred because — although no tax is due at the time of the transfer — if the exchanged land is sold in a few years for \$15,000, the taxable income is \$14,000 (\$15,000 minus \$1,000). In most cases, the original seller will be pleased by the deferral because he can pay the tax in the future with future dollars — not at the time of the exchange.



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## Like-kind property

For Section 1031 to apply, the property received must of a like-kind to the property given. Like-kind is defined as property held for productive use in a trade or business or for investment that is exchanged solely for similar property. Properties are of like-kind if they are of the same nature or character, even if they differ in grade or quality. Real properties generally are of like-kind regardless of whether the properties are improved or unimproved.

## Deferred exchange

Since it's difficult for a seller to find a buyer willing to exchange land at the same time, Section 1031 provides the same tax deferral for a delayed exchange. A typical deferred exchange involves a seller, buyer, intermediary and replacement property owner. The property sold is "relinquished," while the land purchased is "replacement property."

The seller and buyer sign a contract with a clause allowing the seller to assign his interest to an intermediary, usually a bank, as part of the exchange. Once the sale contract is signed, the seller and bank sign a separate agreement, and the seller assigns his interest to the bank. The transaction closes with the buyer paying the purchase price of the relinquished property directly to



the bank, and the seller deeds it to the buyer.

It's crucial that the buyer pays the purchase price directly to the bank and not the seller. If the bank is an agent of the seller, or the seller becomes entitled to possess the money from the sale of the relinquished property, the transaction will not qualify as a Section 1031 exchange.

The seller has 45 days from the date the buyer receives title to the relinquished property to send written notice to the bank identifying the replacement property that the seller wants the bank to buy to replace the relinquished property. The seller then enters into a purchase contract with the owner of the replacement property, including a clause that the bank can assume the land as part of a Section 1031 exchange.

After the seller and replacement property owner sign a purchase contract, the bank assumes the contract and closes the deal by paying the purchase price to the owner of the replacement property. The owner deeds the property to the seller.

To qualify under Section 1031, the replacement property must be deeded to the seller within 180 days of the date the buyer received the relinquished property.

The seller has no taxable income unless the relinquished property sold for

more than the purchase price of the replacement property. If so, any cash the seller received will first reduce his basis in the replacement property to the extent of the money received. Once the basis is zero, any additional cash received is taxable income in the year of the exchange. Otherwise, the seller will have the same basis in the replacement property as in the relinquished property.

## Reverse exchange

In a reverse Section 1031 exchange, the seller acquires the replacement property first and within 180 days finds a buyer for the relinquished property. This exchange uses a fifth party — an accommodation titleholder — to facilitate the transaction by technically holding the replacement property until a relinquished property buyer is found.

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