

The Like-Kind Exchange and Recent Developments in Section 1031 Law

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Under Section 1031 of the Internal Revenue Code, investment or business property owners may exchange real or personal property currently held for investment or productive use, for comparable like-kind property, and defer the capital gains tax that would ordinarily be paid until the replacement property is ultimately sold.

The 1031 exchange rules were developed out of an idea of fairness. Normally when a citizen sells property, the taxable income from the sale is calculated by subtracting the value of what was received, minus the sold property's "basis." Though this is oversimplifying its definition, basis represents the seller's original stake in the property, often the amount he paid for it originally. So if you buy property for \$50 in 1980 and sell it in 2000 for \$100 dollars, you have value received of \$100, a basis of \$50 and a taxable gain of \$50.

Normally it does not matter what type of valuable item you receive for your property. If you receive money, the total amount received is used to calculate gain. If you receive property, then the fair market value of the property received is used to calculate gain.

This model can sometimes create unwelcome results. If two people exchange pieces of land, and each ends up owning land comparable to what he had before, why should that be a taxable event? To resolve this problem, the tax code has provisions satisfying those who think it unfair that people can end up in essen-

tially the same economic position as they had started, but pay taxes as if they had sold their property. (There are some who object to this model on the idea that if the replacement property is not somehow more valuable than the relinquished property, why would you choose to make the exchange? I will leave this philosophical conundrum up to the reader).

Section 1031 was designed to alleviate this problem by allowing exchanges of comparable or "like-kind" property to be allowed tax free if certain requirements were met.

Like-kind property is defined as property held for productive use in a trade or business or for investment that is exchanged solely for similar property. Generally no gain or loss is recognized on the exchange of like-kind 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; however, real property in the United States and real property outside the United States are not like-kind properties.

Almost as soon as the 1031 like-kind rules were developed, people looked for ways to expand upon them and apply the rules to varied situations. Taxpayers immediately sought ways to allow transactions where the exchange of property was not simultaneous. This is done through the use of a "qualified intermediary." The intermediary (often a bank) acts as a middleman who allows the taxpayer to transfer

property, wait 45 days to identify new property to acquire in exchange (replacement property), and 180 days to acquire it. These rules greatly increased the flexibility of the 1031 exchange.

The Reverse Exchange.

The greatest innovation in 1031 exchange law in recent years has been the allowance of the reverse exchange by Revenue Procedure 2000-37 of the IRS in September 2000. In a reverse exchange the taxpayer acquires the replacement property first and then later (within 180 days) finds a buyer for the relinquished property. This exchange uses an accommodation titleholder to facilitate the transaction by acting as the technical holder of the replacement property until the buyer of the relinquished property is found.

Reverse exchanges have been a controversial idea for years; therefore, the rules regulating them are much stricter than for other exchanges. It is important to follow the guidelines very carefully.

Important Changes for 2003 and 2004

New 5-year holding requirement. The IRS now provides that a taxpayer can exclude capital gains pursuant to a Section 121 Exclusion from the sale of his or her personal residence, if the property was originally acquired as rental property as part of a 1031 Tax-Deferred Exchange transaction. **New for 2004.**

New 50% special depreciation allowance. You can claim a 50% special depreciation allowance for qualified property acquired after May 5, 2003, and placed in service before January 1, 2005. The 30% or the 50% additional first-year depreciation allowance is subject to depreciation recapture.

Reduced capital gains tax rates. The maximum tax rate on net capital gain has been reduced for individual taxpayers for sales, exchanges, or conversions of assets after May 5, 2003. The lower rates (from 20% to 15% and from 10% to 5%) apply to assets held

more than one year (and installment payments received after that date).

Qualified 5-year gain eliminated. The 8% maximum tax rate for qualified 5-year gain has been eliminated for sales and other dispositions after May 5, 2003 (and installment payments received after that date).

Of course, these are only a few of the updates and changes for like-kind exchanges. Qualified attorneys can greatly enhance your ability to successfully navigate the rules of 1031 exchanges. For further information on like-kind exchanges, please contact your Denton & Keuler attorneys.

About Ted Hutchins

Ted's experience at Denton & Keuler spans a broad spectrum of business law and taxation, including purchases, mergers, acquisitions, and business planning. His skill has been invaluable to clients arranging multi-million dollar mergers as well as to those planning for closely held businesses. Ted also concentrates his practice in estate planning for clients with needs ranging from basic wills to more complex estate and gift tax planning. Ted's email address is thutchins@dklaw.com.

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